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STATE AND LOCAL GOVERNMENT FINANCES AND THE CHANGING NATIONAL ECONOMY

HEARING

BEFORE THE

SPECIAL STUDY ON ECONOMIC CHANGE

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-SIXTH CONGRESS

SECOND SESSION

JULY 28, 1980

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STATE AND LOCAL GOVERNMENT FINANCES AND THE CHANGING NATIONAL ECONOMY

MONDAY, JULY 28, 1980

CONGRESS OF THE UNITED STATES,
SPECIAL STUDY ON ECONOMIC CHANGE
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Richard Bolling (vice chairman of the committee) presiding.

Present: Representatives Bolling, Reuss, Long, and Mitchell.

Also present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC; Deborah Matz, Keith B. Keener, and Mayanne Karmin, professional staff members; Mark R. Policinski, minority professional staff member; and Betty Maddox, administrative assistant.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, VICE CHAIRMAN

Representative BOLLING. The committee will be in order. I would be pleased if the witnesses would take their places at the table. One of our witnesses will be here later. I am pleased to welcome the distinguished witnesses here today.

As you may know, at this hearing, Roy Bahl, director of the Metropolitan Studies Program at Syracuse University, will present the findings of his study "State and Local Government Finances and the Changing National Economy." This study was prepared for the Joint Economic Committee's Special Study on Economic Change, which was initiated in 1977 to provide a long-range analysis of the Nation's economy and the implications of the future.

The various other papers undertaken for the Special Study have either been completed or are in their final stages of completion. While they all explore and analyze important questions concerning the Nation's future, the study on State and Local Government Finances is of particular interest to me.

Since 1949, when I was first sworn in as a Member of Congress, I have seen an explosion in the growth of intergovernmental aid and in the size and importance of the State and local government sector. In 1950, State and local government expenditures represented 8 percent of our GNP, today it is approximately 14 percent; in 1950, Federal grants to State and local governments totaled $2.3 billion, representing 10 percent of State and local government expenditures, in 1980, it is $89 billion or 25 percent of State and local government expenditures.

READEX FICHE

Not only are State and local government expenditures more dependent on Federal aid, but the national economy is more likely to be affected by changes in the State and local government sector as well.

In recent years, local and regional economies have been dramatically altered by massive shifts in jobs and population. Many previously thriving industrial cities have found plants closing, unemployment rising, the middle class leaving, and their fiscal structures decaying. Other cities experiencing rapid growth in population have found that their stock of housing, schools, roads, and sewers is no longer adequate, that services must be expanded, and crime is rising.

In attempting to deal with these problems, the various levels of government continue to duplicate some functions and totally neglect others. The intergovernmental system has become a morass of redtape, forms, and mandates. Programs are developed largely on an ad hoc basis with little regard for efficiency or coordination either between different agencies or levels of government. Even a seemingly simple effort, such as targeting based on need, has proven virtually impossible to achieve because of competing local and regional interests within the Congress.

The task before us is great indeed. But I believe one of the major problems confronting the United States is that the Government does not work very well—not just the Federal Government, but the Federal Government in relation to other levels of government.

Of course the future of State and local government finance will directly impact this relationship and also influence the state of our national economy. At this point, I do not think we can talk about the future of our national economy without considering the health of the State and local sector. And, if the outlook for the State and local sector is not bright, it seems to me that we must develop policies and programs which are responsive to their needs. I say this not only because I believe the Federal Government has an obligation to its subnational governments and their residents, but, moreover, because our national economy cannot thrive if one of its vital organs is ailing.

I, therefore, ask you, our experts, what you foresee for our State and local governments in the coming years and what actions you recommend for the various levels of government to deal with the problems before us?

Before I call on the witnesses, I wish to ask if either of my colleagues or both desire to make a statement.

Representative LONG. No, thank you.

Representative MITCHELL. No, thank you.

Representative BOLLING. Thank you. I will proceed to call on the witnesses in alphabetical order and we will start with Mr. Roy Bahl. We are delighted to have you.

STATEMENT OF ROY BAHL, PROFESSOR OF ECONOMICS AND DIRECTOR, METROPOLITAN STUDIES PROGRAM, THE MAXWELL SCHOOL, SYRACUSE UNIVERSITY, SYRACUSE, N.Y.

Mr. BAHL. Since I have submitted the manuscript to the JEC's Special Study as well as a prepared statement of my remarks to-

day, I will just take a few minutes to outline what I think are the most important points.

Representative BOLLING. Proceed exactly as you wish.

Mr. BAHL. I would like to talk about three issues. The first is the set of underlying factors that will shape the outlook for State and local government finances in the 1980's. Second, I would like to venture what I think probably will happen over the next 5 years. Third, I will make some suggestions about appropriate Federal, State, and local government policy in the face of what surely will be quite severe problems.

First, with respect to factors shaping the outlook, I believe, as will most other witnesses who testify, that the performance of the national economy is the crucial factor shaping the outlook for State and local government finance. I can offer some rough numbers: If the growth rate in GNP is between 3 and 3.5 percent on the average over the next 5 years, that would suggest that the rate of growth in State and local government taxes will fall from about 4.3 percent to something on the order of 3 percent annually. A reasonable guess might be that Federal aid will fall from a growth rate of 7.3 percent per year to about 5 percent per year. Together, these possibilities suggest that the growth in resources available to State and local governments will be about 25 percent lower in the first 5 years of the 1980's than it was from the period 1965 through 1975. So the first major factor shaping the outlook is that there will be a lot less public money available.

The second factor shaping the outlook will be regional shifts in economic activity. By most projections, including my own, the shift to the Sunbelt will probably continue. It shows no signs of changing in terms of the rate of movement of people, jobs and income out of the older Northeast and Midwest to the newer regions of the country. The basic reasons why the shift in economic activity is going on are still with us and include relative costs of doing business, people's preferences for where they live, energy cost and availability, and a number of other factors.

What is important here is what kind of fiscal adjustments have been made. I would argue the first round of adjustments to the Sunbelt shifts have been made in many of the Northeastern States, but they have been very difficult. They are difficult because these States face very heavy fixed commitments in the area of debt and pensions because local government is very important in these States and it's hard to control the actions of a great number of local government, because labor is more unionized, and because of the psychological problems of lowering the high level of public services.

In the South, such adjustments are a newer problem. There will be a slower rate of growth in terms of resources available to State and local governments, but the shortfalls will not be as bad as in the North. On the other hand, population growth creates pressures to expand infrastructure and Southern States will feel that pressure. Sooner or later, public sector unions will spread south as the Southern economy looks more like the rest of the country—I should say the newer regions, including the South and West. So rapid growth will have an effect on the South and adjustments will be necessary there.

The third factor is the limitation movement. I need not say much about it except that it should be considered at the Federal level, in

terms of affecting the flow of Federal moneys to State and local governments, and at the State and local government level where it will, for a while, slow the amount of resources available—to local governments in particular.

Finally, there is the question of revitalization. How much revitalization is going on in the big cities in this country? The arguments go that there are three trends to make us believe that cities will begin to revitalize themselves.

The first is the changing demographics. There are more old people, singles and childless couples, and the city is more attractive to these groups because of amenities. Second, energy costs will make people move closer to their jobs and back to the cities. Third, there is a bright lights argument, such as cities are more interesting to live in because they offer more things to more people. There is not really very much evidence that these factors are operating. As to the demographics, people may be postponing having children and schools will remain a major problem in the cities. If energy costs are important and people move closer to where they work, they will move to suburbs rather than cities because that is where more people work. The bright lights argument is a good case for Georgetown or Manhattan but hardly fits Syracuse or Utica, or any number of smaller cities where commuting distances are not great. There is not much evidence of a revitalization movement sweeping the country.

As far as the 1980's, I would venture a prognosis about what might happen. First, this slow growth in the economy probably will result in a reduction in resources available to State and local governments. I would guess more than a reduction of about a fourth in the rate of increase in revenues flowing to State and local governments in the older regions of the country. Second, I think there will be defaults in the first 5 years of the 1980's. It is important to note that there are a lot of ways to default. There may well be defaults of the kind where bondholders don't receive payment, or these shortfalls may be covered by short-term borrowing, or there may be an inability to meet other commitments. There are more financial disasters or emergencies ahead in the next 5 years. I am sure we all have our list of candidates.

Third, the capital obsolescence problem will grow in the cities. Cities have been deferring investment in maintenance, in the renewal of their capital stock, because of shortages of resources and because of competing claims on those resources. Those deferrals will continue, especially now that the revenue situation is going to be so tight. It will continue even more if there is a further slowdown in Federal moneys.

Fourth, one doesn't need a crystal ball to know that some States will amass considerable surpluses, those States that levy ad valorem taxes on oil and gas resources. Fifth, there will be another catchup in public employee compensation. We talked about that pattern through the 1960's and early 1970's as public employees caught up in terms of average wage rates and pensions and other fringe benefits. Now they have fallen behind again.

One can't believe that they will sit by and stay behind. So there will be another wage catchup in the North. In the Southern States, the average State and local government wage rate is very low by comparison with the rest of the country. As the South and the West grow in terms of their income level, I think we will see an acceleration of the

rate of compensation increase to public employees there. All of this means that a lot of the resources available will go toward paying wage rates to keep them up with inflation. I would guess very little to be left over to increase real level services.

Effective tax rates will grow in many of the States in growing regions, particularly those that don't rely heavily on oil and gas resources. The limitation movement will probably not significantly slow the rate of growth in State and local spending after the next few years. I think that citizens probably recognize the thing that bothers them most probably isn't going to be solved by keeping taxes low.

As a result of all this, there probably will be much less emphasis, by State and local governments, on redistributive services. The needs to increase the rate of compensation and to meet the problems of a deteriorating infrastructure will leave little to go around for income distributive services. I expect to see much less of an increase in spending on health, education, and welfare than we did in the past decade.

Finally, I would offer some very general suggestions here about policy. It seems to me that if we had a national urban policy to address this prognosis for the 1980's, it would have four elements in it. They are elements that I didn't read in the last national urban policy or at least didn't read them the way I wanted to.

First, I think there must be a clear statement about whether we are talking about compensation or revitalization with respect to cities. If our argument is revitalization, we better be sure that subsidy programs of one kind or another can work to revitalize cities. I would argue there is not much evidence suggesting that such programs can increase the population size of cities relative to their suburbs. Compensation strategy would suggest there is an emptying-out process, a national convergence in income and population shares that has to go on. While this is going on, the Federal Government's role ought to be to protect the low income in the regions that are emptying out. Some kind of transition policy is necessary.

Second, national urban policy should recognize the business cycle. Everyone knows this problem and has talked about it again and again. We need a countercyclical policy that comes into effect when we are in a recession, not when we are out of it.

Third, Federal policy seems ambiguous about the role of State government. State government has been bypassed, on the one hand, with an enormous direct flow of Federal money to cities. On the other hand, there is a trend that suggests State government is becoming more and more important in the sense of financing a greater share of local services and directly spending for local services. Somehow there needs to be elimination of this ambiguity. Will we make the States a full partner in the process and make them deal with problems such as city-suburb disparities or are they to somehow be left out of the Federal-State-local relationship?

Fourth, if there is anything that should be in a national urban policy it is a statement of what we will do about default or major financial emergencies. The New York City crisis can be forgiven because we had no experience with that kind of default since the depression. So New York City was a special case. Then Cleveland was special. Then Wayne County. How many special cases will there be before we have some kind of policy? If we get a policy, it must raise a couple

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of questions. The first is: What are the conditions necessary for initial Federal involvement? Can we have a city on the verge of bankruptcy while the State government is reducing taxes? It may be perfectly legitimate, but there needs to be some sort of Federal statement about that.

In addition, who will pay the price of the cutback? Public employees in the form of frozen wages? Citizens in the form of eliminated services? Bondholders who must wait? Welfare recipients? These are parts of a Federal policy. Maybe Federal policy simply says these are not Federal matters.

Finally, there is the question of State and local government policy. What I would say here, if, for the moment, I could address only the problem in the older region of the country, is that public services may get far out of line with resources available to finance those services. In New York State the level of income per capita is around 4 percent above the national average. On a per capita basis, State and local governments in New York spend 40 percent above the national average. That imbalance can't be sustained.

The only solution to that is probably to lower the level of public services. That is very tough as a policy to follow.

Representative BOLLING. That is why Congress doesn't face up to the policy.

[The prepared statement of Mr. Bahl follows:]

PREPARED STATEMENT OF ROY BAHL[1]

In this very brief statement, I would like to discuss the underlying factor which shape the outlook for state-local government finances, offer an opinion about what might be an appropriate Federal, state and local government response to the problems which surely lie ahead, and conclude with a forecast, or guess, about the likely performance of state and local government finances in the 1980's.

FACTORS SHAPING THE OUTLOOK

That state and local governments everywhere are facing problems of adjustment is a reflection of the changing structure of the U.S. economy. A slowing national income growth and a shift in its regional distribution, a continuing high rate of price inflation, a changing population structure, changes in Federal budget and Federal grant policy and a new voter resistance to big government and regulation all exert important pressures on the financial condition of state and local governments and all call for some form of policy responses by state and local governments. In truth, the changes are less recent than some policy analysts should be willing to admit—the slower rate of income and population growth has been recognized for several years now as has the ongoing pattern of regional shifts in population and economic activity. But old fiscal habits die slowly and adjustments take time. The growth in government is just beginning to slow and the realities of long-term retrenchment are only now taking hold in some jurisdictions in the declining regions. The reverse is true in the growing regions where increasing costs and the pressures to upgrade services are beginning to affect state and local government budgets.

National economic growth

The prognosis for the 1980's is for real GNP to grow more slowly than in the 1960's and 1970's. Between 1970 and the first quarter of 1980, real GNP growth was positive in seven years and averaged 4.5 percent in those years. For the ten

[1] Professor of Economics and Director, Metropolitan Studies Program, The Maxwell School, Syracuse University. The statement is drawn from my larger manuscript, "State and Local Government Finances and the Changing National Economy," prepared for the Joint Economic Committee's Special Study on Economic Change. The views expressed here are my own.

years of positive growth rates in the 1960's, the average was 4.1 percent. Certainly the next two years will not begin to approach this rate. The Administration has projected a real GNP decline in 1980 and a real growth of only 2.0 percent in 1981.[2]

Few will hazard outright projections of GNP five years in the future, but 4 to 5 percent real growth rates in the early 1980s seem unlikely. The Administration estimates that in order to achieve a 4 percent unemployment rate by 1985 and a 3 percent inflation rate by 1988, annual productivity increases of 2.5 percent and real GNP growth rates in the 4.5 to 5.0 percent range will be required. To the extent these long-term inflation and unemployment targets are not attainable, slower real income growth will result.

One important reason why the more optimistic scenarios such as the real growth targets set by the Administration may not be reached is that the inflation rate will likely remain high in the 1980's. Some of the underlying causes of inflation have been building for more than a decade and cannot be swiftly corrected. Others are a result of world events—oil pricing and production decisions and crop failures—and are not controllable.

The Bureau of Labor Statistics has made baseline projections of a 3.2 to 3.6 annual real growth rate in GNP for the 1980's. Even these projections require that inflation slow to 5.5 percent in the early 1980's and to 4.4 percent by the end of the decade, and that the unemployment rate gradually fall from a projected 5.3 percent level in 1981 to 4.5 percent by 1990.[3] CBO has simply assumed (calculated) a 3.8 percent growth rate ". . . so that by 1985 the unemployment rate would return to approximately the current level (5.9 percent)."[4] The Joint Economic Committee, assuming productivity increases in the 1.5 to 2 percent range, sees the long-term rate of real GNP growth to be in the 3 to 3.5 percent range.[5] From almost every vantage the conclusion seems to be the same. For at least a few years, the U.S. economy is going to grow more slowly than it did during the past two decades.

The combination of slower real growth and inflation will put new pressures on state and local government budgets. Forecasts for the state and local government sector are not generally available, but it would seem reasonable to assume that taxes will be off their post-1975 annual real growth rate of 4.3 percent. If the past few years is representative and if tax limitation movements do not further slow tax revenue growth, a 3.5 to 4 percent real GNP growth could imply a state and local government tax revenue growth of 2.7 to 3.1 percent per year. The resulting revenue gap will not likely be made up by increased Federal assistance. To the contrary, if the Federal grant share of GNP remains constant, a 3.5 to 4.0 percent of real GNP growth will bring a 4.6 to 5.3 percent annual increase in Federal grants. Even this projection, which seems on the optimistic side, is for the growth well below the 7.3 percent annual real increase of the 1975–1978 period.

The import of all this seems clear. State and local governments will have less resources available in the 1980's—the overall rate of revenue increase could fall by as much as one-fourth if the real GNP growth rate stays in the 3.5 to 4 percent range.

Regional shifts in economic activity

The slowing down of national economic growth will be more than offset in some regions by the inmigration of economic activity. In the older declining regions it will be reinforced. The prospects are for the movement of people and jobs to the newer region to continue through the end of the century. Estimates of regional population and income growth by the Department of Commerce[6] and

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[2] Congressional Budget Office, "Five-Year Budget Projections: Fiscal Years 1981–1985," pt. II (Washington, D.C.: U.S. Government Printing Office, 1980), p. 3.

[3] Norman C. Saunders, "The U.S. Economy to 1990: Two Projections for Growth," in "Employment Projections for the 1980s," Bureau of Labor Statistics, U.S. Department of Labor, Bulletin 2030 (Washington, D.C.: Government Printing Office, 1979), pp. 12–24.

[4] Congressional Budget Office, "Five Year Budget Projections: Fiscal Years 1981–1985" (Washington, D.C.: Government Printing Office, 1980), pp. 2–5).

[5] Joint Economic Committee, "The 1980 Joint Economic Report" (Washington, D.C.: Government Printing Office, Feb. 28, 1980), pp. 30–32.

[6] U.S. Water Resources Council, "1972 OBERS Projections (Series E Population)" (Washington, D.C.: Government Printing Office, April 1974); and Bureau of Economic Analysis, Regional Economic Analysis Division, "Population, Personal Income and Earnings by State: Projections to 2000 (Washington, D.C.: Government Printing Office, October 1977).

regional population and employment growth by the Oak Ridge Laboratory [7] are in agreement on this outlook. Census population projections offer a similar prognosis.[8]

There may indeed be forces operating to slow regional shifts by improving the comparative advantage of the older industrial states. If so, these turning points are so recent that they have not been detected. A more likely prospect is for a continuation of the Sunbelt shift of the 1970s. Regional movements of population and economic activity will pressure state and local governments to adjust their fiscal behavior. For some Northern states the scenario will be continued, long-term retrenchment. As a State like New York attempts to bring its per capita expenditures (40 percent above the U.S. average) into line with its per capita income (4 percent above the U.S. average) the central issue becomes how to lower the level of public services relative to other states. Few states have experience with such matters. Yet governments in the Northern states are beginning to gain a comparative advantage in these matters, having gone through a first round of retrenchment. The political decisions to cancel some programs, postpone others, and lay off employees are more easily made the second time around.

Such an adjustment process is not only slow, but it is complicated by a number of factors.

Inflation is driving up government costs faster than government revenues, accentuating real service level declines.

Slower real income growth cuts into an already thin margin of revenue coverage.

Many Northern states are characterized by highly decentralized fiscal systems, hence it is difficult for the state government to plan for or control the aggregate level of state and local government spending and taxing.

Because of jurisdictional fragmentation the fiscal position of central cities in the declining regions is likely to be hurt a great deal more than that of suburbs, i.e., much of the costs of retrenchment are ultimately paid by low income families.

There are important psychological barriers to retrenchment—residents find it much easier to adapt to lower taxes than to adapt to lower public service levels.

The strength of public employee unions, fixed debt and pension commitments, a backlog of needed infrastructure improvements, and the existing near crisis financial conditions of many cities make substantial retrenchment an especially difficult process.

The net result of all this is that while regional shifts in economic activity demand that the formerly rich states bring their fiscal activities into line with their new, relatively low levels of income, the retrenchment process probably involves a period of public sector atrophy in the North. This means that governments probably won't and can't cut back service levels in the absolute, but if they do not raise tax burdens or expand the quality and quantity of services and spend just enough to keep real per capita expenditures approximately constant, in time the rest of the country will catch up. This process is long and slow, but it is the kind of adjustment that is most likely to occur.

The growing regions will also face fiscal adjustment problems. On the one hand, there is the great amount of rural poverty in the South and Southwest and there is need to use substantial amounts of the revenues from growth to deal with these problems. Then there are the pressure from growing population and income to expand infrastructure, improve school and health systems, deal with water shortages and environmental problems and control land use. The growing regions would seem more equipped (than most Northern States) to deal with these pressures, for a number of reasons:

Resources are growing because of regional shifts, even though national growth is slowing, and because tax structures in the growing regions tend to be more inflation-sensitive than those in the Northeast and Midwest.

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[7] Oak Ridge National Laboratory, "Long-Term Projections of Population and Employment for Regions of the United States" (Oak Ridge, Tennessee: December 1978); and, R. J. Olsen, et al., "Multiregion: A Simulation-Forecasting Model of BEA Area Population and Employment" (Oak Ridge, Tennessee: Oak Ridge National Laboratory, October 1977).

[8] U.S. Bureau of the Census, "Population Projections of the United States: 1977–2050." Current Population Reports, Series P25, No. 704 (Washington, D.C.: Government Printing Office, July 1977).

Government finances tend to be more state dominated and therefore more controllable.

Many urban areas are not characterized by fragmented local government structures.

Some states will experience substantial revenue growth with rising energy prices.

On the other hand there are state and local government financial problems ahead for Southern states. Much of this increase in spending could come in the form of a catch-up in average wages, hence expenditures may rise more rapidly than public service levels. State and local government employment levels, relative to population, are already higher in Southern than Northern states.

The limitation movement

It is not likely that the tax revolt movement which closed the 1970s signals a permanent reversal in the growing share of government in GNP. But it seems clear that fiscal limitations of one kind or another will be a significant influence on state and local government budgets during the next five years. By mid-1979, thirty state legislatures were considering amendments calling for a balanced Federal budget and 14 states passed some form of tax or expenditure limitation between 1978 and 1980. The mood is clearly in the direction of slowing the growth of government at all levels.

The explanations of this dissatisfaction are many: increasing tax burdens in an inflationary period when real disposable income is falling, and high property taxes head the list. Another source of discontent is what is perceived of as an inefficient public sector—one that is thought to be overpaid, underworked, and not responsive to citizen needs. Whatever the reasons for this dissatisfaction, it seems likely that some state and local governments will be tied to personal income growth in terms of what they are allowed to spend.

The effects of fiscal limitations, if they stick, will be to reduce the discretion of government decision makers in formulating new programs and taxes and in altering the timing of their own fiscal expansions and contractions. Even though there is an option to switch to user charge financing (a compensating device used in the aftermath of California's Proposition 13), it is clear that local fiscal planning will be more constrained then in the past and new spending initiatives will likely be bypassed to meet increased spending for "less controllable" budget items.

It is less clear what the effect on aggregate state and local government fiscal activity will be. On the surface, tieing tax and expenditure growth to personal income growth would suggest a dampening effect. Yet 13 of the 14 states which have imposed such limits are in the growing region—only Michigan is a declining state. Hence even with limitations, a growth in taxes above the national rate of income growth could occur (though one might speculate that it would be even higher without the limitation). Moreover, in nearly every case the limitations apply only to state government. In total, the effected governments account for no more than one-fourth of total state and local government revenue raised from own-sources. It is difficult to see how the limitations per se would significantly hold down aggregate state and local government spending.

Perhaps a more significant effect on the budgets of state and local governments is the possibility of limitations at the Federal level. Even without a legal indexing of Federal expenditures, the tax revolt movement will bring pressure to balance the Federal budget more frequently than has been the case in the past. Some of this balancing will result in reduced resources available for Federal grant-in-aid programs and in a further dampening effect on state and local government revenues.

The limitation movement gained some momentum in 1978 and 1979, and still more states will probably adopt varying kinds of controls on their budget growth. But inflation, public employee wage demands, Federal assistance cuts and slow economic growth will eventually catch up with some limitation states and stall the movement in others. The limitation and austerity concerns of this year could give way to a renewed worry over deficient public service levels by the mid-1980s.

State legislatures will eventually reason that limitations aren't going to address the underlying problem of an inefficient public sector that so rankles many taxpayers, nor is it clear that it will stimulate local economic development as others hope. Further, limitations may cause state and local governments to make revenue-raising adjustments such as increased use of benefit charges and

the creation of special districts. Such policies may well be in the public interest under many circumstances, but not likely if their adoption is justified as a way around a formal limitation. The adjustments by state and local governments to circumvent debt limitations, and the efficiency and controllability of these agency arrangements, is a lesson worth remembering.

Revitalization

Some observers of urban problems see a revitalization of central cities taking place. It is not usually made clear whether revitalization means increased city population, employment and income, an improved economic position of the central city relative to suburbs, or simply a physical rehabilitation of certain parts of the inner city. Some, who borrow the term "gentrification" from the British, see it as the process of filtering housing (or neighborhoods and retail districts) upward from working class to professional middle class. Whatever the meaning, the implication is that the inner cities of the future will be much less the distressed areas that they now are and that Federal policy toward cities ought to be adjusted accordingly. Indeed, some public policy is premised on the ability to induce more employment and residential activity in depressed inner city areas. A national development bank and tax abatements for construction investments in blighted areas are good examples.

The revitalization argument is made on a basis of a priori reasoning, casual observation, and wishful thinking. It has several elements. First, the changing demographics may favor central cities over suburbs. More singles, childless couples and elderly in the national population mix; the demand for rental housing, smaller and less expensive housing; and the convenience of city living (mass transit, walk to shopping, etc.) will bring people back to the city. Moreover, the deterrent of poor public schools in central cities will be less important for families without children. Second, the energy crisis will favor the city. Worker will move closer to work—and perhaps to where mass transit is available—to avoid the longer and more expensive commute. Third, there is the "bright lights of the city" argument. Cities are exciting places to live with more cultural and social activities, and some new awareness of these benefits will bring back white collar, middle income workers. Finally, there are the agglomeration effects which make the city a competitive location for certain types of white collar and service business activities. As evidence of revitalization, proponents give many examples: a booming Manhattan, Chicago's loop, and Capital Hill-like neighborhood revivals in most large cities.

Acceptance of the revitalization arguments as a basis for policy making is better than wishing on a star. But not much. There is little evidence that city populations are increasing, that their relative (to suburbs) income and employment levels are rising or that their disadvantaged are better off. Indeed, none of these patterns have materialized. Central cities declined in population by about 5 percent between 1970 and 1978, they declined as a share of metropolitan area population and employment, and the city/suburb per capita income disparity has grown.

If there has been a back-to-the-city movement, it has been dwarfed by the effects of those factors which stimulate decline. Even the a priori arguments on revitalization seem flawed. There is some appeal to the notion that childless couples and singles see the city as a desirable location because they are not deterred by poor quality schools and because of proximity to amenities and work. Yet the postponement of having children does not necessarily mean that couples will remain childless or that children will not be planned for. Indeed, some have argued that the fertility rate in the United States will soon begin to increase. If this occurs, the quality of the public schools remains a major drawback to city residential location choices. Locations closer to amenities may also be a comparative disadvantage of cities, e.g., most cities cannot compete with the convenience and choice of suburban shopping centers and in all but a few large cities, the mass transit system would not seem a major inducement.

The energy argument might be questioned. There are more suburban than central city job locations hence if the rising price of gasoline induced any population movement, it may well be to suburban locations. Moreover, if the commute to work grew too expensive, other kinds of adjustments might be made: e.g., a four-day workweek or innovations in communications to minimize necessary personal contact. To the extent movement took place in response to commuting costs, it would likely be blue collar manufacturing workers moving to suburbs. Some white collar workers might be lured to the city, but again the quality of the public schools would be an important impediment.

The "brightlights" argument is based on a notion of cities being exciting centers of cultural and social activity which make city living more exciting. The impression is true enough, perhaps, for a Manhattan or a Georgetown but would hardly seem to fit Syracuse or Toledo.

This is not to argue that revitalization is undesirable, that cities should not be brought back. Rather it is an argument for care in defining revitalization and for realism in assessing what can happen in cities during the next decade. Revitalization can mean a conservation of capital facilities, reinvestment in blighted areas and a general improvement in the quality of city life. This pattern would be perfectly consistent with shrinking population and employment, the displacement of the poor from dilapidated housing in rundown neighborhoods, and the continued loss of manufacturing employment. Revitalization of cities, in this sense, may be a reasonable expectation. But it will not mean a diminished need for Federal help in compensating for the economic losses, subsidizing the disenfranchised and generally getting through a tough adjustment period.

FEDERAL POLICY

The Federal government will play a major role in getting state and local governments through the difficult fiscal adjustment period which lies ahead. The question is whether the Federal response will be reasoned and comprehensive or ad hoc and piecemeal. It seems essential that some general guidelines for the Federal response be worked out, i.e., the kind of strategy one might expect to find in a well though out statement of National Urban Policy. In the absence of such a statement, some very rough generalizations about how such a policy might view the financial problems of state and local governments is offered here. These generalizations might be framed as four questions about the appropriate Federal response to urban problems; wnether the Federal government ought to attempt revitalization of declining areas or compensation during a period of financial adjustment; whether inflation and recession ought to be viewed as a part of intergovernmental policy; what role should state governments play in the intergovernmental system, and what will be the Federal policy toward the big city financial disasters which may lie ahead.

Compensation versus revitalization

If the Administration's Urban Policy statement of 1978 took any firm position, it was toward a revitalization rather than a compensation strategy.[9] The National Development Bank, the targeted employment tax credit, Neighborhood Commercial Reinvestment programs and expanded UDAG funding all seemed to lean toward renovating a deteriorated economic base in distressed cities. At least the rhetoric of Federal policy would imply a belief that the declining economies can be revitalized. Yet there is little evidence that such programs work or have any effect on the employment base of declining cities.

A compensation policy would take a different tack. It would accept the notion that market forces are affecting a reallocation of population and income within the country and attempt to compensate the most financially pressed governments and families caught in this transition. The goal would be to protect particularly the low income by subsidizing both the provision of public services and temporary job opportunities while the emptying out process goes on. Public service job programs, categorical grants in the health and education area and Federal relief of welfare financing would be key elements of such a program.

There is a fine line between revitalization and compensation strategies and one wants to be careful not to confuse the latter with any program to abandon cities or declining regions. As interregional variation in the relative costs of doing business and in market size approach some new balance, movements in population and jobs will slow. A primary role of Federal policy is to assist the most distressed governments during the adjustment process. Hence, subsidies to hold businesses in a region are not an appropriate part of a compensation strategy, if it is known that the business will leave (or cease operations at present levels) when the subsidy is removed. "Transition" grants to states with an overdeveloped public sector, such as New York, are appropriate if they are tied to longer term reductions in the level of public sector activity. Capital grants to renew the city's infrastructure are also appropriate, if the infrastructure investment is

[9] "New Partnership to Conserve America's Communities," Office of the White House Press Secretary, Mar. 27, 1978, p. 9.

based on a "shrinkage" plan. Finally, relocation grants and labor market information systems are perfectly consistent with such a strategy in that they facilitate the outmovement.

The business cycle and intergovernmental policy

The business cycle and inflation have dramatic effects on the financial health of state and local governments. Indeed, it was the severity of the last recession that pushed New York City over the edge and brought many other local governments and at least one state dangerously close to fiscal insolvency. Because swings in economic activity do induce substantial changes in relative fiscal health, one might argue for an explicit recognition of business cycle effects in Federal intergovernmental policy.

In a sense this was done with countercyclical aid and the stepping up of other components of the Economic Stimulus Package in the last recovery, but it was done in an ad hoc manner rather than as part of a coordinated Federal intergovernmental policy. The basic objectives of CETA were initially training and employment of the disadvantaged and then countercyclical stimulus, and Local Public Works was meant to stimulate state and local government construction. Some would argue that both became general purpose fiscal relief programs, and that neither exerted a strong stimulative effect on the economy. Indeed, if the primary purposes of these programs were training and economic stimulus, neither will pass muster in terms of an evaluation of their success.

Apparently, little was learned from this experience about the relationship between countercyclical policy and national urban policy. The fact is that with the United States economy into another recession, there is not a firm countercyclical policy.

If business cycles were linked to intergovernmental policy, an essential feature of the system would have to be targeting on relatively more distressed jurisdictions. This raises the especially thorny problem of identifying those communities most hurt by recession, and the severity of the recession in the various regions. The evidence of the past two recessions seems clear—the older manufacturing belt in the Northeast and Midwest was hit hardest. Expectations are for a similar regional impact of this recession.

The role of State governments

An ambivalence—at the Federal level—about the "proper" role of state government in state and local government finances may exacerbate some of the problems created by inflation and a slower growing economy.

State governments raised 58 percent of all state and local government taxes, made 40 percent of direct expenditures and accounted for 72 percent of Federal aid in fiscal year 1978. Yet state government seems to be approaching a new crossroads—a redefinition of its fiscal role. The past decade has seen two important, but contradictory, influences on state government financing and service delivery. The first is in respect of its relationship with the Federal government and its place in the intergovernmental system. Total grants-in-aid have quadrupled since 1970, but much of this growth has been in direct Federal to local grants, with the states being bypassed. In 1978, local governments were directly receiving 28 percent of total Federal aid to state and local governments, as compared with 13 percent in 1970. This policy of direct Federal-local relations is not inconsistent with the view from some state capitols that city financial emergencies are as much Federal as state government responsibilities. Now, as the end of the General Revenue Sharing authorization approaches, the Administration has recommended elimination of the state share. Whether or not state governments have brought this change on themselves by abrogating their responsibility toward urban governments is debatable, but the drift toward reducing the importance of state government in the intergovernmental process seems real enough.

The second way in which the state role is changing is in the continuing shift of financial responsibility from local to state governments. The state government's share of total state and local government taxes collected rose from 50.7 percent to 58.5 percent between 1965 and 1978, and the state's share of direct expenditure increased from 34.9 to 39.5 percent. The state aid share of total state expenses remained about constant between 1965 and 1978, but the state government share of health, education and welfare direct spending increased markedly. States may not have done all that they should to lift the financing burden off the local property tax, and too little may have been done about city/suburb fiscal disparities, but the trend toward more government tax or expendi-

ture limitations, a more elastic state government tax structure and high rates of inflation could accentuate this trend.

In fact, the increased Federal-local aid flow may have slowed the trend toward state financial assumption. Before 1975, state aid had behaved as though it were a highly elastic tax, i.e., for every 1 percent increase in personal income, there was a 1.6 percent increase in state aid to local governments. That responsiveness fell to 0.96 percent in 1976 and 0.69 in 1977.

With resources limited, it seems imperative to develop a less ambiguous Federal position about the role and responsibility of state governments. Is fiscal centralization to be encouraged or not and should states—as a prerequisite to Federal assistance—be required to deal with the city/suburb disparities problem?

Default and emergency loans

Financial emergencies if not default lie ahead for many large cities. If it does nothing else, a national urban policy ought to outline the Federal response to such crises. Dealing with New York City on an ad hoc basis was excusable—there had been little reason to be concerned with municipal default since the depression. In many respects the New York City crisis of 1975 was a special case. But how many special cases can there be before a policy response must be made? Cleveland and Wayne County have much in common with New York City in terms of weaknesses in the underlying economy, as do many of the other cities which commonly appear on the distressed lists.

Two questions are essential in formulating a Federal policy toward distressed cities. The first involves defining the conditions necessary for initial Federal intervention, i.e., what avenues must be exhausted before emergency Federal subsidy is warranted? The second is what adjustments must the city make as a condition of receiving the aid. Neither question seems to have been clearly thought through and neither is to be found in the Administration's Urban Policy Statement.

On the first issue, one might query the role of state government as having a prior responsibility for city financial problems. Should there be an emergency loan to New York City when New York State runs enough of a surplus to cut taxes? Some would argue that the Clevelands and Detroits are primarily the business of the Ohios and the Michigans and Federal bailouts are a last desperate resort. The view from the Statehouse is likely to be quite different. State governments could well argue that a combination of local autonomy, Federal mandates and direct Federal-local aids have taken much of the potential for control of local fiscal excesses out of their hands.

Federal actions stimulated the local fiscal and may have created some of the risk of default, hence, the Federal government should participate as at least an equal partner in the bailout. The state argument seems strong. In order to require states to shoulder more responsibility for the fiscal problems of their local governments, the Federal government must be less ambiguous about the role of state government in the intergovernmental system. If states are to have first claim on filling the financing gap of cities facing financial emergencies they might reasonably argue for more control over service level mandates and resources passing through to the local level. The elimination of the state share of General Revenue Sharing would hardly seem a step in this direction.

If cities' financial conditions are to be viewed independently of state government, then a set of criteria for local fiscal actions which must be taken prior to Federal intervention should be established. These might include emergency tax levels, program and employment cutbacks, a wage freeze, and perhaps debt rescheduling.

The second issue is how far will local governments be required to go in altering their fiscal behavior as a condition for continuing to receive an emergency loan or grant, and how will the fiscal improvements be monitored? The most important question to be resolved is how will the Federal government opt to distribute the burden of an austerity program. Employee layoffs and wage freezes will lay much of the burden on public employees, program cutbacks and tax increases on citizens and bond repayment stretch-outs or moratoriums on bondholders. A Federal policy which accommodates a bailout in a period of emergency, will implicitly or explicitly make such choices.

Another alternative is to make it clear that the Federal government will not rescue cities from default, even in the case of the most severe emergencies. Even as a statement of national policy it would be difficult to make this believable with the history of New York City, Lockheed and Chrysler. But if local and state governments were convinced that a borrower of last resort was not available,

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their financial practices may become much more conservative and their fiscal strategies more risk averse. Whether that would be in the national interest is precisely the sort of question a reasoned national urban policy should address.

STATE AND LOCAL GOVERNMENT POLICY

A National Urban Policy is essential. State and local government financial problems will materialize in the 1980s and a coordinated Federal response will be imperative. Yet most of the required adjustments will fall to state and local governments, the vast majority of which are neither distressed nor flush.

The fiscal fates of state and local governments will be determined largely by factors outside their control—inflation, the performance of the national economy, and the level and distribution of Federal grants. Still, state and local governments have considerable discretionary powers to influence their financial health during this period of adjustment.

The most popular reform is to offer a program for productivity increases. It is popular because it does not cost the taxpayer, can be used as a basis for rewarding public employees and best of all, its success or failure can't be measured. The need for and possibilities of state and local government employee productivity increases make great discussion material, but they do not balance budgets.

A second strategy is the use of tax and subsidy policy to stimulate regional economic development. State and local governments in both growing and declining regions attempt to improve their competitiveness as a business location by offering various kinds of subsidies, e.g., tax abatements, tax holidays, subsidized loans, grants of land, etc. Whether these subsidies have actually contributed to local economic development is as debatable as the issue of whether the induced revenue gains from new business have exceeded the expenditure costs.

Probably the most important strategy in which governments in the declining region can participate is retrenchment, i.e., the adjustment of public service levels and the growth in expenditures to properly reflect capacity to finance. Retrenchment involves cuts in service levels and employment, a more realistic look at the kinds of compensation and benefit levels that can be afforded, and a careful conservation of those capital resources that are available. With respect to the latter, one would expect to see a great deal more emphasis placed on maintenance and renovation of the existing capital stock than on the construction of new capital facilities. The austerity programs in some cities have included these kinds of adjustments, but other public policies have been surprising. Relative tax burdens have gone up in the declining region, the fiscal limitation movement has pretty much been limited to the sunbelt, and public employment rolls in the declining region have expanded in the past two years.

In the growing regions, local governments also face serious adjustment problems which will require them to carefully plan the growth in their budgets. The problems are essentially how much should a government grow and how fast should this growth occur. The mistakes of governments in the older region might be avoided if the long-term expenditure implications of fiscal decisions are evaluated against the potential long-term growth in the local resource base. Fiscal planning and forecasting is a relatively new art and science, but is being used effectively in many cities, especially those in the growing region.

The most pressing of the fiscal adjustment problems are keeping the infrastructure development in step with population and employment growth. With rising material and capital costs, and the prospects for less Federal aid, this could become a serious bottleneck to growth. At the same time there is the danger of allowing growth to become too rapid and uncontrolled and to lead fiscal development to a point where there is no possibility for careful long-term budgetary planning.

STATE AND LOCAL GOVERNMENT FINANCES: THE NEXT 5 YEARS

Guiding principles from a National Urban Policy and optimal fiscal adjustments by state and local governments are more wishful thinking than realistic expectations. The likely performance over the next five years will involve a series of financial crises and ad hoc Federal responses. The following would not seem too unreasonable a scenario:

> The national economy will go through a recession and begin a period of slow real growth. Inflation rates will remain high by comparison with the early 1970's and 1960's.

Some local governments—mostly but not exclusively large cities in the North—will either default or come to the point of being unable to meet their expenditures commitments. A round of public employee layoffs—reminiscent of 1975–76—will probably take place.

Despite the recognition of capital obsolescence problems, the quality of the capital stock, especially in the older regions, will continue to deteriorate. Higher interest rates, inflation, reduced Federal aids and pressing financial problems all will push state and local governments to further 'defer' capital construction, maintenance and renovation.

With rising energy prices, some of the oil and gas rich states will experience extraordinary revenue increases, and amass considerable surplus funds.

The next five years will see another catch-up in public employee compensation rates. This lagged effect of recent years deferred compensation increases will be further stimulated by the current high inflation rate, and will account for virtually all of the public expenditure increases of some jurisdictions. The increase in average wages will be especially rapid in the South where average wages are relatively lower and where unionization is increasing.

Relative levels of tax burdens will rise in many states in the growing regions in response to increasing costs and service quality, and will decline in the Northeast as austerity programs begin to take hold.

The limitation movement will not significantly slow the rate of state and local government spending after the early 1980s.

Federal policy toward state and local government finances will remain ad hoc, and there will be no guiding principles. The overall level of Federal grants (in real terms) will likely decline and less targeting might be expected during the next five years as the growing region more forcefully makes its point about the fiscal needs related to rural poverty.

The near-term future likely holds less emphasis by state and local governments on redistributive activities. Social service program expansions will take a back seat to capital maintenance and renovation needs and public employee compensation and the recent rate of income tax increase will not be maintained.

These guesses would be altered by either a coherent Federal government policy toward state and local government finances or by a better performing United States economy. In the last analysis there could be no better National Urban Policy than a low inflation rate and a strong growth in GNP.

Representative BOLLING. I will proceed alphabetically. Mr. Laffer, please begin.

STATEMENT OF ARTHUR B. LAFFER, PROFESSOR, DEPARTMENT OF FINANCE AND BUSINESS, SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF SOUTHERN CALIFORNIA, LOS ANGELES, CALIF.

Mr. LAFFER. Thank you.

If you don't mind I would like to have my prepared statement placed in the record. I can always remember back in school, when my teachers told me I should never move my lips when reading.

Representative BOLLING. You want the full statement put in the record?

Mr. LAFFER. Yes. I will summarize.

Representative BOLLING. That will be done without objection in all cases as requested.

Go ahead.

Mr. LAFFER. What I would like to discuss today is some of the overall issues of State and local financing and the economic health of different regions of the country.

If I can harken back to economic theory, it is a trivial tax theorem that if you increase taxes on the production of a product in one loca-

tion, producers tend to move from that location to alternative lower-taxed locations.

An increase in tax rates in a product has two effects. The first effect is to raise the price purchasers pay. The second is to reduce the price that suppliers of the product receive.

By raising the demand price, demand for the product is reduced. By lowering the supply price, the supply of the product is similarly reduced.

The first theorem here is that an increase in taxes on the production of a product in one location causes problems in those regions.

The second theorem pertains to the proceeds from taxes in the overall region. If the proceeds are used in production encouraging fashions, output growth will be reduced by less or perhaps increased. If the proceeds are used to reward nonproduction or provide resources for agencies or groups, and so forth, to regulate or restrict or in some way diminish the incentives for production, you will find you have a two-fold disincentive effect here.

Not only will the producers have to pay the taxes and thereby diminish incentives for production, but also they will have to use resources to comply with the regulatory agencies and the nonproductive efforts.

In research carried out over the last few years, we found a strong and systemic relationship between those States that raised their tax rates and those that have grown exceptionally slow.

Those that raised their tax rates relative to the norm grow slower than the norm. Those that lower their tax rates relative to the norm tend to grow faster than the norm. There is not one example of a State that increased its tax rates inordinately relative to the national average that at the same time grew substantially above the national average. Several States, frankly, are able to grow slowly and still have low tax rates because of other problems, but no State that we could find increased its relative tax burden and was able to grow exceptionally swift.

If you look at the major policy option—and here I agree with Mr. Bahl completely—the primary benefit that can be bestowed upon State and local governments must ultimately come from the U.S. economy.

The basic benefits to be achieved on a State and local government level are overall U.S. economic policies.

I would like to refer you to a study by Professors Canto and Webb and Joines. They looked at the effects of the Kennedy tax policies in the 1960's on State and local government financing. They used time series analysis to estimate the overall output employment and production effects as well as the revenue effects for State and local governments through income taxes, both Federal, corporate, and personal income tax receipts, from the Kennedy tax cuts in the early 1960's.

As a result of the tax rate reductions, State and local revenues over 2 years—just income tax revenues of State and local governments—were increased by $3 billion. Putting that figure in current dollars, that would be about $8 billion over 2 years.

But even the $8 billion figure grossly understates the total effect that could happen today. In the early 1960's, State and local governments relied far less heavily on income taxes than today. If you look at the larger reliance today on income taxes for State and local governments, a proportionate tax rate reduction effect encouraging output and em-

ployment, a la the cuts of the 1960's, that could well result in an increase in net revenues to State and local governments of something like $20 billion.

Even here, I underestimated the overall fiscal effect. If you cut tax rates and increase economic growth, you will reduce unemployment, and the numbers of those people falling into welfare categories. Obligations will be diminished.

They wouldn't have to pay unemployment compensation or spend as much on welfare. Not because any one person had benefits cut off, but because they provide the best form of welfare; a good high-paying job.

The effects of a stimulated U.S. economy through increased incentives via tax rate reductions—would be the primary way to benefit State and local governments today.

As a last point, I would focus on one area where I lived much of my life and carried on a lot of my research—the inner city and the role of incentives in the inner city. I taught at the University of Chicago for almost 10 years and lived on the South Side of Chicago, a place called South Short. If the plight and damage befalling this inner city could be rectified or even mitigated, the burdens and problems placed on State and local governments would be greatly alleviated.

Let me describe a study I did when I moved out to the University of Southern California, where I am now. I went down to the university area, the inner city in Los Angeles. This work took place some 2 years ago. I took a hypothetical family of four and assumed there were two adults and two children in the family. One of the adults for whatever reason couldn't work but received no unemployment compensation whatsoever. The other adult could or couldn't work as he or she saw fit.

I said, let's imagine the adult who can work decides not to work but receives no unemployment compensation. The family of four has no earnings whatsoever. What is the maximum legally available social welfare benefits this family can acquire with no earnings whatsoever?

I went through and got the bonus value food stamps, subsidies, medical whatever. The total spending of the family of four came out to $718.33 per month.

Then I said, let's imagine the one adult who can work decides to work and earns $100 gross per month. We then took that $100 gross and took out the payroll taxes and income taxes and got the net earnings after taxes. We then recalculated the maximum legally available benefits this family could acquire at that level of income. With the means and needs tests that applied to benefits, we calculated the maximum benefits available, and we added the two together, and got the total spending power at $100 gross earnings. Do you follow this? $100, $200, $300, $400, on up to $1,000 a month. We found the increase in total spending power for a family of four going from zero earnings to $1,000 a month is a grand total of $140 in the city of Los Angeles, as of 2 years ago.

This corresponds to an average tax rate in the inner city of only 86 percent. How many people would work at an 86 percent average tax rate? We found between $300 and $800 a month, the spending power of the family of four literally declines. This corresponds to marginal tax rates in excess of 100 percent if they follow the law precisely.

Does it come as a shock to anyone that black unemployment rates

in the inner city increased quite dramatically relative to white? Or the participation rates of blacks in the labor force fell relative to whites.

Representative BOLLING. I would answer for one person. It doesn't. I voted for two Nixon welfare reforms on the ground that anything was better than nothing.

Mr. LAFFER. Not only that, but anything is better than literally paying people not to work and providing these enormous disincentives. What we found, I would urge the committee to consider that we are providing with our programs aimed at the inner city, we are providing great disincentives to work effort. Inner-city residents work for after-tax income like anyone else. Incentives are what they work for.

I would like to suggest that the committee and others here consider some sort of removal of these disincentives. I would suggest that you make inner-city regions—you have companies locating within inner cities paying lower income rates on profits generated by plants in those locations.

Two, that plants locating within the inner city which employ people whose principal residence is the inner city, that payroll taxes are eliminated or reduced greatly to a certain level.

Third, most serious of all is the minimum wage which is a 100 percent tax rate on many black teenagers in the city. Get rid of it at the very least, or reduce a lot of the disincentives.

Last, I would suggest that all Government spending programs directed to States and localities frankly have as a mandated requirement a thorough review of building codes, restrictions, regulations, and requirements. I guess maybe to put this into a politically responsible context, there is a bill today that would do part of this. I agree with major portions of the bill, though there are some parts with which I disagree. It is cosponsored by Congressmen Kemp and Garcia. Bills like this would have a major impact on revitalizing the inner city, which would have the effect of financing of State and local government.

Thank you.

Representative BOLLING. Thank you, Mr. Laffer.

[The prepared statement of Mr. Laffer follows:]

PREPARED STATEMENT OF ARTHUR B. LAFFER

A useful hyperbole of the perverse effects high tax rates may have on the fiscal solvency of government is to query whether New York City should attempt to solve its fiscal solvency crisis by raising its tax rates thereby driving the last two businesses out of the city. While the question as posed omits a multiplicity of extenuating circumstances and admitted complexities, it strikes at the core of the fiscal problems faced by American state and local governments. Taxes, as everyone knows, aren't everything; taxes are, as everyone knows equally as well, quite important. The question also contains the essential elements of a real life tragedy. While the answer to the question starkly posed is obviously "no", the answer, more often than not, when beleaguered with masses of data and tomes of studies, ends up in the affirmative.

Just last week Mayor Koch announced that a number of tax rates in New York City probably would have to be raised some $600 million in order to maintain and improve the city's fiscal picture. The effects of such actions are nowhere more obvious than they are in New York City. In the 1950s New York City was the citadel of American affluence and growth. Today, after fifteen or twenty years of even-higher rates of taxation, New York City is beleaguered with poverty, decline, and fiscal crises. New York Citry's effective rates of taxation on personal income, sales, and even cigarettes, are by now generally well known. Less known

is the high tax incidence on manufacturing. In one report to the Mayor in 1976, the following passage occurred:

> A comparison of tax liabilities for some sample locations demonstrates the tax disadvantages of operating in New York City . . . While certainly far from precise, these estimated tax liabilities do illustrate the variation in tax structures. For example, excluding potential sales and user taxes, the tax liabilities for White Plains, New York is approximately 23 percent greater than it is for Honey Creek, Indiana. If sales and user taxes are included, the difference increases to 32 percent. More startling, however, is the difference between New York City and White Plains, where the basic difference amounts to 40 percent. If sales and use taxes are included, the difference between New York City and White Plains comes to 114 percent.[1]

With the inordinate increase in all forms of tax rates during the 1960s and 1970s is it any wonder that James Ring Adams concluded:

> During two previous recessions, in 1957–8 and 1960–1 New York suffered the loss of fewer jobs than the rest of the country. But in the recession of 1969, New York lost jobs at three times the national average, and things continued to get worse in the next few years as the rest of the country recovered. In the severe recession which lasted from November 1973 to September 1975, New York City's job loss accelerated to a rate six times the national average. In 1968, the City's unemployment rate had been one half of a percentage point below the national average, placing it second lowest in a Bureau of Labor Statistics survey of fourteen major cities. In September of 1975, New York City's unemployment had reached 11.1 percent, some 2.3 percentage points above the national rate, giving it the second highest rate among the same fourteen cities.[2]

It is a trivial tax theorem that higher taxation on the production of a product in one location vis a vis other locations will result in the shift of production away from the higher taxed location and into the lower taxed location. Quite obviously, for some industries which are highly dependent on the location of natural resources or specific markets, differential tax rates will have a relatively small effect on their choice of alternative locations. Thus, mining operations, hydroelectric power plants and Statute of Liberty tour companies would be hard pressed to alter their cite facilities. But, for the vast majority of productive enterprise, the selection of the appropriate location is a viable option. And businesses base that decision, in part, upon tax considerations.

Higher rates of taxation have two general affects on overall market behavior. An increase in rates of taxation will have the effect of increasing the price purchasers of a product must pay. This in turn will reduce the demand for the product. Furthermore, an increase in the rates of taxation will lower the price producers of a product receive for supplying the product. Less will be supplied. In sum then an increase in tax rates will result in lessened demand and supply and thereby will diminish the overall amount produced within the higher taxed region. An increase in tax rates reduces output while a reduction in tax rates increases production. The faster tax rates grow the lower growth rates will be.

Not only does the overall level of taxation matter but so does its composition. The higher taxes are on mobile factors of production relative to immobile factors, the lower output will be even when the overall level of taxes is given. Henry George, the nineteenth century American economist, made the point in the following manner:

> The mode of taxation is, in fact, quite as important as the amount. As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be improverished and the power of producing wealth destroyed by taxation, which, if levied in another way could be borne with ease.[3]

And among the many states and localities within the United States there exist numerous forms of taxation. Some are far more efficient than others. Most recently, the state of Alaska has made a dramatic shift in the means by which state government collects revenues. Alaska has imposed a severance tax on the extraction of oil and has, in part, used the proceeds to lower income and other

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[1] "The Effects of Taxation on Manufacturing in New York City," Ninth Interim Report to the Mayor by the Temporary Commission on City Finances, December 1976, pp. 34–6.
[2] Adams, James Ring, "Why New York City Went Broke," Commentary, May 1976, pp. 21 and 32.
[3] George, Henry, "Progress and Poverty," Robert Shalkenbach Foundation, 1979, p. 409.

forms of taxation. From the standpoint of economic theory this shift in the tax incidence should have beneficial effects on Alaska's economic performance in the years ahead. First, Alaska's oil reserves are not mobile and therefore a tax on them will merely reduce the cite value of oil land and have little impact on the production of oil. Second, people are quite mobile and the reduction of state income taxes should induce immigration into Alaska of the group of high income earners. And lastly, the ownership of the oil drilling rights while in the proximate sense may be by oil companies, in its final sense is by a wide cross section of Americans, few of whom are Alaskan residents. Thus, the fall in market value of Alaskan oil drilling rights will reduce the share values of oil companies and be spread across the broad base of American shareholders. Thus, the burden of Alaska's tax shift will fall primarily on non-Alaskans while the benefits will accrue to Alaska. The circumstances may well not be optimal for the country as a whole but for Alaska it is exceptionally good. New York City, on the other hand, is doing its part to help Alaska grow faster by driving its enterprising individuals out by ever-higher rates of taxation on market successes.

The final general point on state and local fiscal policy that basically closes the full loop, is that the composition of spending along with the total amount of spending and the composition of taxes matters, and matters a lot. If the disposition of government receipts is generally used to enhance the attractiveness of the specific region then growth will be lessened less or even increased. If however, the proceeds from taxation are used to further harm the productive sector through payments to non-producers or to provide the wherewithal for regulatory agencies and enforcement agencies to impose unnecessary and unwarranted rules and regulations on the productive sector, output will be doubly diminished. Not only will the producers have to pay the taxes and thereby experience lessened profitability, but they will also have to divert their resources to either combat or comply with the well funded government regulatory agencies. When productive opportunities finally would arise these enterprises would have to compete with lucrative governmental welfare programs for the services of the potentially employable.

Harking back to the experiences of New York City between 1950 and 1960, government employment grew 9 percent while total employment grew 2 percent. In the decade of the sixties the ratio became more unbalanced with government employment growth at almost 38 percent and total employment growth at almost 6 percent. The piece de resistance, however, occurred between 1970 and 1975. Within that five year span government employment grew 9.3 percent and total employment shrank by 12.5 percent.[4] In fact, employment in each and every industry save government declined. With regard to welfare, James Ring Adams had this to say:

> . . . the social services, i.e., welfare portion of the expense budget has swelled from 11 percent in 1962–3 to 23 percent in 1972–3 . . . in raw figures, money spent on welfare programs has ballooned over the decade (1962–3 to 1972–3) from $338 million to $2.1 billion, a six-fold increase. The raw welfare caseload has tripled over the decade. Since individual benefits have also increased, welfare payments have quadrupled. In spite of ten years of increasing prosperity, about 1.3 million New Yorkers are on the dole.[5]

To summarize then, economic theory would have us believe the following:

(i) The total amount of taxation should affect the economic well-being of an individual state or locality. The higher taxes are, the less well the region will perform relative to the rest of the country. The lower taxes are, the better will be the performance.

(ii) Separate from the total amount of taxation, the composition of taxation should also affect the well-being of a state or locality. The greater taxation is on mobile factors and the lower taxation is on immobile factors, the lower will be economic growth. Conversely, the lower the rates of taxation on mobile factors and the higher on immobile factors, the greater growth will be.

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[4] Data are to be found in "The Effects of Tax on Manufacturing in New York City," op. cit.

[5] Adams, James Ring, "New York's Unwelcome Chickens," The Wall Street Journal, Jan. 21, 1975.

(iii) Separate from the total amount and the composition of taxation, the composition of spending should also affect a region's economic health. The more spending is directed toward the non-productive or anti-productive segments of the economy and away from enhancing the productive segments, the lower will be the region's economic growth. Likewise, the more governmentally controlled resources are used to foster growth and the less they are used to reward non-growth or actively to restrain growth, the greater growth will be.

Recently, a number of my colleagues and I have carried out research of both a theoretical and empirical nature on the fiscal determinants of state and local economic growth. The theoretical conclusions were basically those enumerated earlier in this testimony. The first major empirical effort focused on the expected effects Proposition 13 would have on the economic health of the state of California.[6] In this paper, which I co-authored with Charles Kadlec, growth rates were found to be highly sensitive to a state's tax policies. In fact, if Proposition 13 were to be passed we estimated that California would lose much less revenue than was being estimated by others at that time and that, in due course, tax revenues would actually increase as a result of the passage of Proposition 13, so powerful were the incentive effects on economic growth. Kadlec and I also concluded that with economic growth came a reduction in the rate of unemployment within the state and also a reduction in the number of people who qualified for welfare. Thus, not only would revenues fall by less and ultimately increase above where they otherwise would have been, but that natural forces would operate so as to reduce government spending on a statewide level. The total budgetary effects, therefore, would be twofold in nature. Both effects would operate to mitigate, if not fully offset, any potential deficit resulting from a reduction in tax rates. More than two years have elapsed since that study was published and the record speaks for itself.[7]

In our report to the Governor of Puerto Rico, Victor A. Canto and I analyzed the past performance of Puerto Rico in some detail.[8] We had been carrying on this research since 1977, shortly after Governor Carlos Romero had taken office. As is documented in the report, we found that the large increases in tax rates and government spending relative to Puerto Rico's production base, commencing in the late sixties, contributed significantly to the retrenchment of the economy in the early and middle seventies. Our recommendation was for across-the-board income tax rate reductions. Puerto Rico, at the request of its Governor, has reduced personal income tax rates by 5 percent per year since 1977 and currently legislated through 1982. Other economic reforms have been made as well. Again, the results are quite straight forward. Employment has grown by leaps and bounds and the state budget has gone into a surplus position. Economic growth is up and unemployment rates are down.

At present, Charles Kadlec and I, along with Professors Canto and Robert I. Webb are working on a series of papers exploring the statewide fiscal policies and their impacts on statewide economic growth. These studies are targeted on the states of Massachusetts and Delaware where we have been commissioned to do the research. In the graph below the relationship between tax rate increases relative to the rest of the nation and statewide growth rates in real personal income, again relative to the rest of the country, are displayed for the period 1967 to 1977. The power of the association is readily apparent. Virtually no state has had an exceptional record of economic growth that has increased its tax rates relative to the rest of the nation. Also included on the graph itself is the actual econometric association between the two variables. The statistical association is unambiguous and explains a large portion of the relative growth differentials (some 39 percent). When numerous other tests were carried out these basic results remained.

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[6] Kadlec, Charles W., and Laffer, Arthur B., "The Jarvis-Gann Tax Cut Proposal: An Application of the Laffer Curve," Economic Study, H. C. Wainwright & Co., June 27, 1978.
[7] Laffer, Arthur B., "California Tax Update," Economic Observations, A. B. Laffer Associates, Mar. 28, 1980.
[8] Canto, Victor A., and Laffer, Arthur B., "Report to the Governor: Recommendations for Economic Reform in Puerto Rico," H. C. Wainwright & Co., Apr. 20, 1979.

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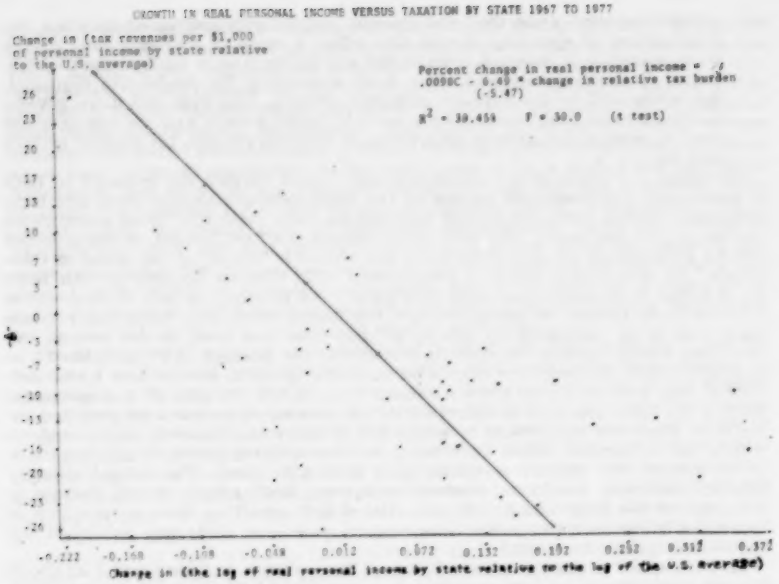

Given the degree of data limitations we were not able to uncover any statistically significant differences in the mode of taxation among the states for this and other time periods. Nonetheless, there do appear to be specific cases, such as Alaska, where those effects emerge as well. What we were able to find, however, is that the composition of spending does matter and matters a great deal. Transfer payments have a specifically deleterious impact on the economic growth of a state when compared to purchases of goods and services. In fact, the deleterious impact also appears to be cumulative. The longer a high level of transfer payments remains in place the greater will be the reduction in the state's rate of growth. We have also carried out rather detailed analyses of statewide employment trends and they, too, tend to corroborate the substantial impact fiscal policy has on the economic performances experienced by states.

Taxation and spending are not the only ways state and local government can impact their region's economic performance. To the extent states impose regulations, restrictions, and requirements, they can materially alter the path of the local economy. Even federal regulations can have substantially different regional implications. President Carter's "Windfall Profits Tax", which in reality is an oil excise tax, clearly impacts the oil producing regions of the country far more than it does other areas.[9] Fleet mileage requirements and emission standards for automobiles will clearly retard the economic advancement of auto producing regions of the country more than they do other regions. The enormous impact on the viability of auto production is documented in a report Charles Kadlec, Kenneth Clarkson, and I prepared for the Chrysler Corporation.[10] Whatever the specifics, which are far too complex to discuss at length here, regulations, restrictions, and requirements can and do have serious implications for regional and statewide development.

The implications of the above discussion may appear somewhat inhumane to some observers. This would be true especially to those people who actively wish to redistribute wealth even if that results in some efficiency losses. The trade-off however doesn't occur in either theory or in actual practice. The relationship

[9] Kadlec, Charles W., and Laffer, Arthur B., "Does Oil Decontrol Mean Lower Prices?", The New York Times, Sept. 2, 1979.

[10] Clarkson, Kenneth W., Kadlec, Charles W., and Laffer, Arthur B., "The Impact of Government Regulations on Competition in the U.S. Automobile Industry," H. C. Wainwright & Co., Economics, May 4, 1979.

between the incidence of fiscal policy, i.e. who actually pays the tax or receives the benefits, and the burden of fiscal policy, i.e. whose after-tax spending power actually rises or falls, is highly complex and basically outside the purview of governmental entities. As often as not an increase in tax rates on one group will hurt other groups more. Likewise, an increase in welfare spending can just as easily reduce the well-being of welfare recipients as it does enhance their well-being. While frequently an advocate of redistributionist schemes, Paul Samuelson, Nobel laureate and economics professor at the Massachusetts Institute of Technology, explains in his principles text why it can't be done:

> Even if the electorate has made up its mind about how the tax burden shall be borne by individuals, the following difficult problems remain:
>
> Who ultimately pays a particular tax? Does its burden stay on the person on whom it is first levied? One cannot assume that the person Congress says a tax is levied on will end up paying that tax. He may be able to shift the tax; shift it "forward" on his customers by raising his price as much as the tax; or shift it "backward" on his suppliers (wage earners, rent, and interest receivers) who end up being able to charge him less than they would have done had there been no tax.
>
> Economists therefore say: We must study the final incidence of the tax totality of its effects on commodity prices, factor-prices, resource allocations, efforts, and composition of production and consumption. Tax incidence, thus, is on easy problem and requires all the advanced tools of economics to help toward its solution.[11]

On an empirical level the results of income redistribution schemes are often to hurt the poor even relative to the well-to-do. Great Britain, for example, has one of the most extensive and comprehensive redistributionist policy frameworks in the world. The poor in the U.K. have not fared nearly as well as have the poor in countries like Japan, Germany, and Switzerland. A casual observation of the relative effectiveness of two islands in the Caribbean in addressing the issue of poverty and unemployment is also to the point. Jamaica has one of the highest and most progressive tax structures of all the islands along with an elaborate structure of subsidies and government transfer programs. Poverty and unemployment are commonplace while the island's government is deeply in the red. Bermuda, on the other hand, doesn't even have an income tax and there appears to be little poverty or despair, and the statewide government seems also to be fiscally sound. Numerous other examples can be found such as a comparison of New York City and the lot of its poor versus Houston, Texas, and the progress in reducing poverty and despair there. Colin and Mary Campbell, in their detailed analysis of the fiscal policies of New Hampshire and Vermont came to similar conclusions.[12] While New Hampshire had far lower tax rates than did Vermont, the provision of public services in New Hampshire was as good, if not better, than that in Vermont.

The difficulty of specifically relating the incidence of a fiscal structure to the burden notwithstanding, the issue, on a conceptual level, is considerably less complicated. The burden of any tax structure is always borne by factors of production in direct relation to the inelasticity of their supply and the elasticity of the demand for their services. Therefore, factors that can escape a tax relatively easily bear less of the burden than those factors that cannot escape. Likewise, those factors whose services are critical to the overall economy bear less of the tax burden than those factors whose services are dispensible. Examination of the post-Proposition 13 situation in California reveals the essence of this result.

While Proposition 13 solely reduced the incidence of taxation on the value of property, its benefits accrued more to the unemployed and disadvantaged than they did to property owners. The reason for this result is simply that the supply of housing and other property is quite elastic and the demand for housing services is highly inelastic. The services of low income earners, on the other hand, are inelastically supplied while the demand for them is quite elastic. Housing and property values have not shown any exceptional appreciation relative to their counterparts in the rest of the nation. In fact, in the eighteen months before April, 1978, housing prices in Southern California rose 40 percent. In the eighteen

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[11] Samuelson, Paul, "Economics," 9th Edition, McGraw-Hill, 1973, p. 175.

[12] Campbell, Colin D., and Campbell, Rosemary G., "A Comparative Study of The Fiscal Systems of New Hampshire and Vermont, 1940–1974," A Report to The Wheelabrator Foundation, Inc., 1976.

months since Proposition 13's passage, housing prices in Southern California rose by only 30 percent.

In 1977, before Proposition 13 was passed, California's unemployment rate was 1.2 percentage points above the national average. Today, California's unemployment rate is either the same as, or slightly below the national average, depending upon which month in which it is measured. Since 1977, California had an increase in employment of more than 1,100,000 people. This increase represents 16 percent of the total increase in jobs in America. Without California's enormous ability to provide jobs, the unemployment rate for the nation would now be in excess of 8½ percent. Thus, California's employment rate, since Proposition 13, has boosted nationwide employment rates. Indeed, California's economic boom has helped keep the national economy from being in worse shape than it already is.

The Federal government gets a windfall from a state's passage of tax rate reductions. Not only will the reduced tax rates lower individual deductions, but the higher incomes that result from the expanded economic base will lead to more taxable income at the Federal level. The problem, however, is not with states enacting tax rate reductions. The problem rests with the fact that the Federal government increases its taxes on any state that attempts to improve the welfare of its citizens by lowering tax rates.

In the extreme, if the objective were to minimize Federal tax receipts, all states could raise income tax rates to 100 percent. Anyone so altruistic as to earn income would have it all confiscated by the State capitols. Because state tax payments are deductible on Federal income tax returns, there would be no Federal tax liabiilties. Few people would work, however, and the results to the citizens of the nation would be disastrous.

The correct approach is for the Federal government to cut tax rates as well, rather than using the Federal windfall taxes as an excuse to keep states from doing what is best for their citizens. All states would be better off without the tax exploitation emanating from Washington, D.C. At the least, the inherent bias against state and local tax rate reductions should be removed by prohibiting deductions of state tax payments from the Federal returns.

States with high tax structures are shackling their own economies without providing long-term benefits. Far from being anti-government the passage of major tax cuts will prove to be a successful measure to attain the objectives of a moral social philosophy. The most immoral act a society can perpetrate on its citizenry is to enact policies which have the effect of reducing the production base from which all beneficence ultimately flows.

The single most important policy the Federal government could pursue to alleviate the fiscal stress of state and local governments is a program to spur economic growth in the national economy through substantial and across-the-board reductions in marginal tax rates. The impact on the Federal deficit of such a program can be debated, since it is difficult to prove absolutely before the fact whether the expansion of the tax base and the decrease in public welfare expenditures created by such a tax reduction would be large enough to offset the deficit augmenting effects of a cut in tax rates. But the impact on state and local fiscal health is unambiguous. Even with state and local tax policies unchanged, an expansion in economic activity implies direcly more revenues, less public welfare expenditures, and improved fiscal conditions for state and local governments. The fiscal impact can be substantial. In their study of the revenue effects of the Kennedy tax cuts, Professors Canto, Douglas H. Joines, and Webb, found that these tax cuts contributed to a substantial increase in state and local income tax receipts above where they otherwise would have been. The cumulative impact in 1963–4 dollars for the three years ending in 1966 was more than $3 billion, approximately 50 percent of its 1963 level.[13]

In today's dollars, a $3 billion increase is equivalent to more than $8 billion. But even that understates by a wide margin the expected revenue impact today, since income taxes at the state and local levels are far more important now than in 1963. Last year, state and local government personal income tax revenues totalled $37.8 billion, while corporate profits tax accruals were $14.3 billion, for a total of $52.1 billion. Thus, tax reductions which are equivalent in magnitude to those passed in the early 1960s could well lead to increases of more than $20

[13] Canto, Victor A., Joines, Douglas H., and Webb, Robert I., "Empirical Evidence on the Effects of Tax Rates on Economic Activity," Paper presented at the American Statistical Association Annual Meeting, Aug. 13, 1979, Washington, D.C.

billion in state and local income tax revenues over the next three years. Sales and other tax revenues also would increase with an expansion in the tax base. And, as has already been discussed, an expansion in the national economy implies a diminution in the demands for government services and the need for public welfare assistance. Thus, it is likely that in an overall economic environment of growth, state and local governments could maintain the present level of public services even while reducing their share of overall economic activity.

The report prepared by Dr. Roy Bahl, and being discussed today, illuminates in detail the growing importance of the public sector at both the Federal and the state and local levels. The last decade has witnessed an extraordinary increase in the size of government at all levels and a notable shift in the emphasis of government programs from the provision of goods and services to the public at large, toward income maintenance and other transfer programs aimed at the less fortunate in our society. Indeed, between 1960 and 1975, the share of Federal aid to state and local governments, accounted for by education, public welfare and social services, increased from 43 percent of total Federal grants to 57 percent. Moreover, Federal aid as a percent of total state and local general revenue more than doubled to 22 percent. At that level, it was the largest single component of revenues for state and local governments.

Bahl makes passing reference, however, to the impact such trends may have had on incentives, and hence the economic health of the taxing entities. Relative growth rates among states are largely assumed to be unaffected by differences in fiscal policies. Since states represent open economies, attempts to spur economic growth through increased expenditures, or especially through reductions in tax rates, are viewed as inappropriate, the added stimulus being largely dissipated across the state's borders; local residents spend a large proportion of their income on goods and services provided from outside of the state.

Without incorporating the role of incentives on economic activity, both the absolute performance of the U.S. economy over the past decade, and the relative performance of different regions in the U.S. are difficult to understand. The overall level of government spending and deficits relative to GNP were never higher than in 1974 and 1975. Countercyclical revenue sharing was introduced in the form of CETA and other targeted Federal aid. Unemployment benefits were increased and extended. Yet, the 1974–5 recession was the most severe since the depression of the 1930s.

A similar paradox appears when examining the relative growth rates among different regions of the country. The slower growing states of the North, by-and-large, have engaged in more deficit financing than the faster growing Southern states. Per capita spending is higher in the North, though the growth in aggregate per capita spending between 1972 and 1977 was approximately the same in the North and South. In addition, the Northern states devote a proportionally greater share of their budgets to transfer payments and other public welfare programs. Interestingly, even though 1977 per capita expenditures in the South were 20 percent below those in the North, state and local government employment relative to population in the South was 8 percent higher than in the North.

In recent years, the often discussed distribution of Federal aid has favored the North, not the South. In 1977, for example, per capita Federal aid was 5 percent higher in the Northern states relative to the South. And, during the period 1975–77, per capita Federal aid increased by a greater amount in the Northern states while the revenue dependency of the Southern states on Federal aid actually declined.

By adding the role of incentives into the analysis of the data provided by the Bahl study, a solution to this apparent paradox is evident. The deepest recession in the U.S. since the Depression occurred at a time when Federal tax rates on production and subsidies to nonproduction were at an historic high. And, when the changes in tax burdens and public welfare expenditures among different states are viewed in terms of their negative impact on incentives, the relative growth rates between the Northern and Southern tiers no longer is surprising.

Nowhere is the understanding of the role of incentives more important than in coming to grips with the failure of traditional government policies to alleviate America's poor, most of whom are trapped in the poverty of our inner cities. As Dr. Bahl says so well in his study:

> . . . perhaps the most significant trend is a change that did not occur. Despite wars on poverty, new frontiers, and model cities, the plight of the urban poor remains intolerable.

As Bahl states, the demise of the inner city that has been witnessed over the past one-and-one-half to two decades is a catastrophe of the first order. If this problem alone could be partially alleviated the plight of America's state and local governments would be considerably relieved. The solution, as I shall attempt to demonstrate, rests not in increased government intervention in the affairs of the inner city, but, instead the problem arises from that same intervention. The solution will come from the reduction in the impact government policies have on the inner city residents' abilities to improve the conditions of the inner cities.

From 1968 through 1976, black male unemployment rates rose from 5.6 percent of the labor force to 12.7 percent. During the same time period white male unemployment rates rose substantially less, from 2.6 percent to 6.4 percent. In every age cohort the probabilities of being among the unemployed has risen by more for the non-whites than it has for whites. Unemployment only tells part of the story. Focusing on the proportion of the population actually employed or seeking work, the participation rate, the tale is equally as grim. From 1968 to 1976 white male participation rates fell from 80.4 percent to 78.4 percent, much of which was due to the change in the age composition of the white male labor force. Black male participation rates, on the other hand, fell from 77.6 percent to 70.7 percent over the same period, while adjusting for changes in the composition of the population does nothing to offset this precipitous decline. Finally, the median earnings of black males employed year round have not risen by as much as those of whites.

While black performance in the market place was rapidly deteriorating relative to white performance, social welfare expenditures on Federal, state and local levels were expanding at unprecedented rates. In conjunction with the rapid increase in welfare outlays, other measures such as increases in the minimum wage were being adopted. Most of these initiatives had the specific objective of alleviating the suffering of the disadvantaged. But, they have had just the opposite result.

In 1965, total social welfare expenditures were just over $77 billion, or 11.7 percent of gross national product. By 1968, these programs totaled almost $114 billion or 13.7 percent of GNP. As of 1975, total social welfare expenditures nearly reached $290 billion, or almost 20 percent of GNP. By far the fastest increases occurred at the Federal level. By 1975, Federal expenditures on social welfare were over four times what they had been in 1965. As a share of GNP, Federal expenditures had doubled. In 1965, state and local expenditures on social welfare were slightly greater than Federal expenditures. In spite of the doubling of state and local expenditures, by 1975 Federal expenditures exceeded state and local expenditures by over $45 billion.

In the persistent effort to achieve parsimony in conjunction with fairness and equity, social welfare programs have adopted stringent criteria for welfare recipients. For social security recipients there is the "retirement" test which reduces the tax free benefits allowed as earned income for the retired rises above $4,000 per year. Similar "means and income" test strictures apply to recipients of food stamps, housing subsidies, aid for dependent children, unemployment compensation, etc. These criteria of eligibility were designed to ensure that only the truly needy would receive the help they so desperately lacked. Excluding people in progressively higher income groups meant that funds would not be squandered on those less in need.

While these "means", "retirement", "incomes", "unemployment" and other "needs" tests may be rationalized on both moral and budget grounds, they have markedly perverse effects on the economic incentives of the poor. At the same time, all sorts of governmental licensing, environmental safety and code requirements have reduced economic incentives for employing the poor. It is difficult enough for a well-educated suburbanite to comply with codes, taxes and licensing requirements. For an inner city, poorly educated individual, these barriers border on being insurmountable. In my own personal experience on the South Side of Chicago, I have observed the deleterious effects of building codes, minimum wages, state and Federal tax filing requirements, business extortion gangs and other impediments on businesses owned and operated by blacks. These impediments alone are so great as to raise the question: why is the inner city doing as well as it is? Yet, still we hear people asking the reverse: given what is spent, why isn't the black community doing better? One look at the difficulty inner city minority residents have in merely filling out driver's license forms, immigrant visas, etc., puts an entirely different perspective on the true issues.

The net effects on spendable income of the combination of "needs" tests and taxes for an inner city family of four in Los Angeles are calculated below. The

family is assumed to have two adults, one of whom is either disabled or unemployed. In addition, we have assumed the family avails itself to the maximum city, county, state, and Federal welfare benefits to which it is entitled given its income.

The impact of incremental increases in gross wages of $100 per month has been calculated up to $1,000 per month. The wage figure is the total cost to the firm for employing one person. The income figures thus include employer contributions to social security and a maximum level of employment insurance contributions.

Several biases exist cutting in a number of directions but the central point is obvious. Marginal tax rates for inner city inhabitants are prohibitively high.

EFFECTS OF INCOME AND TAXES ON FAMILY SPENDABLE INCOME FROM WAGES AND WELFARE BENEFITS

	Net family spendable income	Increase in spendable income	De facto marginal tax rate (percent)
Monthly gross wages: [1]			
0	$718.33	(2)	(2)
$100	759.43	$41.10	58.9
$200	780.53	21.10	78.9
$300	810.57	30.04	70.0
$400	815.80	5.23	94.5
$500	794.58	−21.22	121.2
$600	794.58	0	100.0
$700	794.58	0	100.0
$800	809.92	15.34	84.7
$900	832.49	22.57	77.4
$1,000	858.58	26.09	73.9

[1] Including employment taxes paid by employer.
[2] Not applicable.

Note.—Applies to a family of 4 in Los Angeles, 1 member of whom is unemployed or disabled.

Source: Arthur B. Laffer and Christopher R. Petruzzi, University of South California.

Over the entire range from no wages to $1,000 per month (equivalent to a gross paycheck of about $900 per month), the family has at its disposal an additional $140.25 per month. This corresponds to an average tax "wedge" of 86 percent. For incomes between $400 and $800 per month, the family's ability to buy goods and services actually falls the more it earns. This corresponds to marginal tax rates of more than 100 percent.[14]

The dimensions of the problems facing America's inner cities are enormous and solutions to date miniscule. The essence of the problems, however, relate to the lack of incentives for the poor to become well-to-do and the disadvantaged to become the privileged. Any solution to the overall plight faced by American cities and states has to focus directly on the poverty traps in the inner cities. This focus must, as a first step, reinstate the primacy of individual incentives. As an initial move, businesses that locate within the inner city should be taxed at lower rates. This removal of a direct impediment to employment would enhance business incentives to bring jobs to where they are needed most. Businesses do not locate their plant facilities as a matter of social conscience. They locate plant facilities to make an after-tax rate of return on their investments. We must make the nation's social conscience conform to human nature and not the reverse.

Secondly, businesses that locate within the inner cities, and employ workers whose principal residence is also the inner city, should be relieved of both employer and employee payroll taxes up to some fixed income amount per employee, perhaps the first $12,000 in income per annum. The minimum wage should be suspended in its entirety for inner city workers, and if that is going too far for the political process, it should at least be suspended for teenagers. On-the-job training is the primary means by which our inner city youth acquire the requisite skills to earn above the minimum wage. Therefore, removal of the minimum wage for teenagers is perhaps the single most efficacious method of providing meaningful job skills. Lastly, all federal programs directed to state and local governments should have as a mandated requirement a thorough review of inner city building codes, regulations, and requirements, in order to assure that they do

[14] Laffer, Arthur B., "Prohibitive Tax Rates and the Inner-City: A Rational Explanation of the Poverty Trap," H. C. Wainwright & Co., Economic Study, June 27, 1978.

not discriminate against economic development. While perhaps a little extreme in the abstract, such a program is workable. The most optimistic sign of the coming of age of a rational approach to the inner city problem is legislation proposed by Congressman Kemp and co-sponsored by Congressman Garcia of the South Bronx region of New York City. Perhaps the story of the Phoenix will someday be more reality than mythology.

Representative BOLLING. Mr. Blaine Liner?

STATEMENT OF E. BLAINE LINER, EXECUTIVE DIRECTOR, SOUTHERN POLICIES BOARD, RESEARCH TRIANGLE PARK, DURHAM, N.C.

Mr. LINER. Thank you, Mr. Vice Chairman. I would like to have my prepared statement included in the record.

Representative BOLLING. Without objection, so ordered.

Mr. LINER. Reflecting partially on the testimony prior to mine, the disincentives we have placed upon individuals have been acknowledged; but the disincentives we have placed upon cities, I believe, is an equally valid line of reasoning. Our cities are now rewarded for stagnation. The community development block grant program and the UDAG criteria are much the same as that for an individual qualifying for welfare.

Through all of this we built a rather elaborate scheme where many cities are not sure whether to be happy or sad about not growing. You qualify for many benefits if you didn't grow. On the other hand, you will lose considerable benefits if you grew. I would submit that it takes a very skilled accountant to advise the mayors of cities as to whether they should be happy or sad about their growth status during the last 10 years.

Be that as it may, my point this morning is to at least get into the record some of the information about the 13 Southern States which I represent, especially the remarks that might tend to eleminate some of the myth about the South. It has been the consensus of the media for the last several years that the Sun Belt has been growing very evenly, that all in the South are prosperous.

All the new taxes from new homes and factories do provide a better style of life. But, this is a region that provided low levels of services, almost as a birthright, from its inception. Incomes and municipal services are still quite low in this region. As far as the growth is concerned, over one-half of all growth in the Sun Belt since 1970 accrued to only two States, Florida and Texas. As one of the political figures in the South quite often puts it, "there is a lot of shade in the Sun Belt." There are many chronic economies—areas that have never had a good chance, where services have not been extensive. No one here would describe them as either overserviced or wealthy communities.

We have many large cities in the South that have the very same problems that are ordinarily described as being only in the older industrial belt of America.

We have viewed and monitored your legislation of past years. As far as the current situation, we feel that there has been legislation offered on grant reform to assist the cities in winding their way through the myriad of overlapping and sometimes conflicting planning require-

ments, and other requirements, that could during the next few years help alleviate some of the normal burden of local government.

The prospect of ever-increasing mandates by the Federal level on State and local governments is another area where I believe some constructive work could be done. There are many States that now require that the State itself set aside money to pay the cost of any mandates that they impose on governments below the State level.

Such a system is one that the Federal agencies and the Congress should look into. I think the question of general revenue sharing to the municipalities is one that we could not leave this table without discussing. I agree wholeheartedly with some aspects of Mr. Bahl's statement with respect to involving the State government in the intergovernmental fiscal system as a creative partner.

I believe that general revenue sharing has been helpful to the localities in the South, especially that provided by the States, since that goes primarily to education. This is one of the higher priorities of the Southern States.

The priority of education has always been highest, and continues to be a very high priority. Most of those revenue-sharing funds go into that category. The cycle that we have is poverty, illiteracy, and welfare dependency.

Near the end of the cycle, you find those without education being on welfare, and we are back to the disincentives to the individual discussed in earlier testimony. If they lack capacity and productivity as an individual, they would not get anywhere. Part of the growth of the South has been a strong emphasis on education, to break the cycle, giving to the individuals the skills with which to participate fully in society. As welfare rolls shrink, local economies will expand.

The balance of my testimony has been submitted for the record.

Thank you.

Representative BOLLING. Thank you, Mr. Liner.

[The prepared statement of Mr. Liner follows:]

PREPARED STATEMENT OF E. BLAINE LINER

That State and local governments experience the same economic hardships as that of families and individuals during recessions is not debatable. Revenue is already down dramatically, especially at the State level where the sales and income taxes serve as the main source of income. In Alabama many schools probably will not open this fall because of revenue shortfalls.

Because of inflation, localities find that the choice of either raising the property tax or shaving services is unacceptable to an already angered consumer of public services. Reassessments are infrequent for the localities that rely so heavily on property taxes. The lag time between increased inflationary values of property and collection of the tax on that new value is long, leaving localities the feeble and fake hope of short run productivity increases to take up the slack.

As we move further into the recession the demand for public services increases. For those areas that are growing, extra taxes on newly constructed homes and factories are helpful. But, in the Sunbelt South over one-half of the total growth between 1970 and 1980 accrued to only two States, Florida and Texas. During the 1974–75 recession Florida's tremendous unemployment problem sapped its tax strength due to recent growth. This time it's the immigrants of Haiti and Cuba. For example, a recent estimate indicates the cost of opening schools for the new arrivals in Dade County alone will exceed $21 million this September.

The southern economy is more complex and more closely integrated with the national economy than was the case 6 years ago. This "integration" of the South into the economic mainstream has been a major factor in the region's strong

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employment and income growth in recent years. But it has also made the South more susceptible to the ripple effects of a national economic downturn.

Some energy-rich States, such as Texas and Oklahoma, will find their State and local coffers full despite the recession; but most Southern States will probably find themselves in a fiscal squeeze a year from now. Southern States tend to have more State-dominated fiscal systems than is the case in other regions, a feature that is reflected by a heavier reliance on nonproperty taxation, especially the sales tax. This difference is of considerable importance since it ties the growth of State/local revenues to the performance of the region's economy. If the coming recession proves to be deeper than anticipated, tax receipts in Southern States may drop dramatically.

For the longer term I believe the fiscal outlook for the Southern States is quite good. In part, this favorable prognosis reflects an expectation of continued economic growth and an eventual convergence of Southern income levels with those of the rest of the Nation. More importantly, the favorable outlook for State and local government in the South stems from a long tradition of fiscal conservatism across the region. We have traditionally had a more modest taste for public goods and services than is found elsewhere, and we have been careful to maintain tax and spending policies that are pro-capital formation and pro-economic development. In this vein, many of our States have passed, or are considering, tax and spending limitations on State and local governments.

I don't want to imply that we have no long-term problems in the South. As our region has grown and we have absorbed increasing numbers of migrants, pressures have been generated for higher levels of public spending for infrastructure and services. While school enrollments have been dropping nationally, they are still rising in the South. Expanding business activity has brought about additional demands for public expenditure. The provision of water, sewage, waste treatment, highways, and other services to new industry entails huge capital outlays as well as continually rising operating costs.

There are many counties and metropolitan areas across the South that are losing population. Rural poverty in the United States is still predominately a Southern phenomenon. And many Southern cities, such as Houston, New Orleans, and Charleston, are sorely in need of rehabilitated infrastructure—a situation identical to that of the Northeast.

Let me turn now to intergovernmental fiscal system itself and suggest some actions Congress can take to help insure a healthy future for State and local governments across the Nation. First, we must tame the virtually unmanageable intergovernmental aid system by promoting more grant consolidation and simplication. We don't need 500 separate Federal aid programs that often work at cross purposes; 160 of these programs have their own individual planning requirements, and each may be subjected to a Federal audit. Too often, at the State level, we find that the Federal aid bureaucrats in Washington are responsive neither to the general public nor to State and local government officials. I heartily endorse the grant reform and grant simplification bills that have been introduced by Senator Jim Sasser of Tennessee.

A second congressional opportunity for improving the operation of the intergovernmental system lies with Federal mandates. Several States, including California, Florida, Montana, Maine, and Tennessee, have a legislative or constitutional requirement that the State must pick up all or a substantial portion of the local cost of State-mandated programs. There is, at present, no comparable requirement for Federal mandates imposed on State and local governments. Yet evidence is mounting that the cost of Federal mandates to State and local governments is susbtantial. For example, a recent study by the Urban Institute prepared for the Joint Economic Committee found that the per capita cost of six selected mandates for local governments came to $33, an amount greater than their per capita general revenue-sharing receipts. Nationally, the total incremental costs borne by State and local governments in meeting Federal mandates may exceed $10 billion. In the interest of intergovernmental equity, Congress should consider covering at least part of the incremental costs associated with Federal mandates on State and local governments.

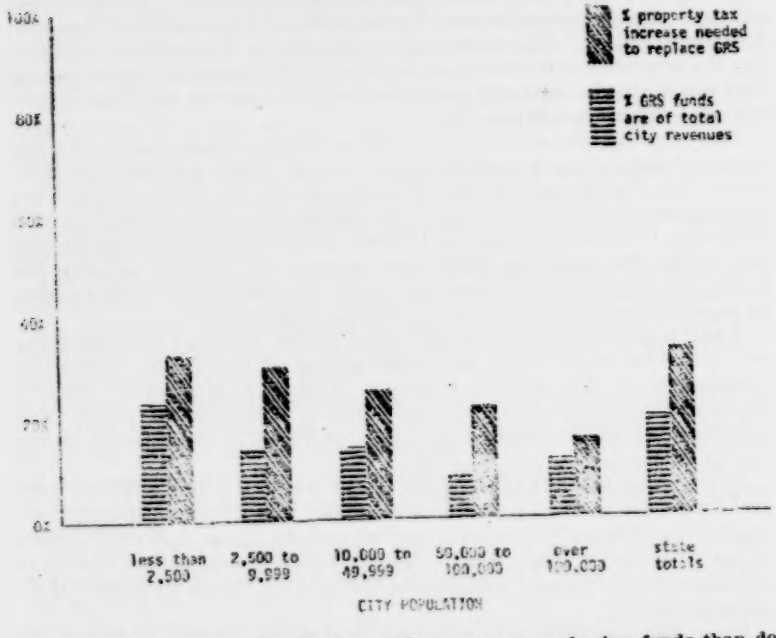
Finally, I would urge the Congress to reauthorize the general revenue sharing program with the State share intact. Given the prevailing congressional mood of fiscal restraint, I expect general revenue sharing for the States to continue receiving strong opposition. But a Federal-to-city relationship that bypasses the State level is not desirable. The States can, will and do play a constructive role at the subnational level.

Research conducted by the Southern Growth Policies Board and other organizations indicates that general revenue sharing has become increasingly important to States and localities across the Nation for the maintenance of existing programs and operations. State governments, especially in the South, but also elsewhere, tend to use most of their GRS funds to support education. On the local level, general revenue sharing provides major budgetary support for fire and police services, sanitation, and transportation programs. Termination or reductions in the GRS program, particularly during a recessionary period, will place undue strain on State and local budgets and create further economic disruptions through tax increases, service cutbacks, and reductions in State assistance to hard pressed localities. A recent survey in North Carolina shows municipal dependence upon general revenue sharing funds to average over 20 percent of the budget of small towns and almost 10 percent for cities over 100,000 population.

Finally, a comment on the velocity with which funds move from Washington to the cities might be appropriate. You have heard testimony in previous days that documented the fact that countercyclical moneys triggered by unemployment rates in 1974–75 had not arrived on site and been committed for goods/services until the label pro-cyclical was more apt. Similarly, great amounts of moneys are unspent in the CDBG program. Many other large fund packages are held victims by EPA, local attorneys and others concerned more with procedure than with result. Finding ways to increase the velocity of public funds is absolutely critical to any countercyclical effort.

NORTH CAROLINA

MUNICIPAL DEPENDENCE ON GENERAL REVENUE SHARING FUNDS



Smaller cities have a greater dependence on revenue-sharing funds than do larger cities. These smaller cities have a high percentage—over 20 percent—of their total cities' revenues consisting of GRS funds and would require a high percent—over 30 percent—increase in their property tax to replace GRS funds.

Source: North Carolina League of Municipalities.

Representative BOLLING. Next, Mr. Felix Rohatyn.

STATEMENT OF FELIX G. ROHATYN, CHAIRMAN, MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK

Mr. ROHATYN. Thank you, Mr. Vice Chairman.

If I may, I will just read my prepared statement which is not very long. I would like to preface it by saying that my view of these kinds of problems is that of a businessman who got involved with the finances of New York City quite by accident 5 years ago, and hasn't quite figured out a way to get out of it. I am not an economist or government expert. I will simply tell you things, at least my perspective of a particular crisis—that of New York City.

Mr. Vice Chairman, the subject of these hearings—State and local government finances and the changing national economy—is one of extreme importance to the future of this country. Inevitably, the hearings pose two issues: One, what to do about State and local government finance, given striking short- and also long-run changes in the Nation's economy? Two, what to do about the American economy?

My experience convinces me that the two questions are inseparable. Congress deserves considerable credit for authorizing a study which links the two, as does Mr. Bahl for carefully and articulately tracing the linkages in the study released today.

Mr. Bahl's study calls for a "National Urban Policy." I second that call and urge the simultaneous formulation of a compatible "National Economic Policy." We cannot hope to attain the first without addressing the second. Furthermore, it is increasingly important to recognize that a meaningful national economic policy is also one which addresses regional differences explicitly.

The combination of inflation and recession which marks our national economy has a general impact on all State and local governments, but that impact is more pronounced and its consequences more devastating in the larger, older, and weaker cities of the Northeast and Midwest. I believe any national urban program must face up to, and deal with, the growing differences among the regions—among the haves and the have-nots—not just in the interest of the hard-pressed, have-not cities but in the interest of the entire country.

The fragile fiscal base of so many major cities of the declining northern tier is a mirror and consequence of the fragile industrial foundation of the region's economy. This is a product of history, demographic shifts, incentives inherent in past Federal policy, and trends in capital investment, and is more recently exacerbated by the energy crisis.

It is a cruel fate that the region of the country which suffers a general long-term economic decline is also poor in oil. Superimposed upon the basic problems of economic decline and the direct differential costs of meeting energy needs, due to climatic differences alone, we now have a State revenue "bonus" awarded to the oil-rich States by virtue of oil price decontrol.

From 1980 to 1990, oil-producing States like Alaska, Texas, California, and Louisiana will collect increased tax revenues amounting to $115 billion. These States can use their vast revenues to lower other taxes, increase services, attract industry by almost unlimited means; their economies and the economies of surrounding States will get significant boosts.

Like a domestic version of the Third World, the Northeast and Midwest, importers of fuel, already in financial difficulties and needy for additional Federal assistance, will bear the burden, creating greater risk of further social and economic distress. I do not say that critically or for the purpose of starting a regional war. I merely note a fact of life which is not going to go away, and which will get progressively more and more acute.

No one will ultimately benefit from this. Even the United States is too small to permit one-half to become a slum while the other half thrives.

It is shortsighted and wrong to believe that State and local governments can deal with these problems from their own resource base. National action is required.

In New York City, our experience over the last 5 years provides insights into what is possible and desirable to expect State and local governments in declining economies to do for themselves and what must be done at the national level. New York City greatly improved its financial position between 1975 and 1980, and this did not come about by the wave of a magic wand. It required, principally, crisis conditions auguring sufficiently ominous prospects to convince the city, municipal workers, businesses, the State, and finally the Federal Government that they had no alternative but to deal realistically with the problem: a working relationship among all parties: and then real sacrifices and contributions from everyone.

The residents of New York City endured higher transit fares, tuition for the first time at City University, and the general impact of real municipal service cuts.

Municipal workers contributed wage deferrals, lower than inflation rate wage agreements and sizable work force reductions.

Banks sacrificed profits in granting the city stretchouts on loans and interest rate reductions.

The State contributed its moral obligation to interim financing, assumed $750 million of direct loans; provided increased State grants and other assistance. The State also devised the basic financial rescue and "watchdog" mechanisms in the Municipal Assistance Corp.—MAC—and the Financial Control Board.

Finally, the Federal Government contributed the loan guarantees.

And yet, after 5 years and all this effort, we face a budget gap in the next fiscal year of over $1 billion and no letup in sight. Considerable tax increases coupled with further layoffs and service reductions will be needed to close this gap since additional State and Federal aid seem unrealistic.

And then what? Then, in 1982, we will have to face another labor contract, which will cost at a minimum another $1 billion over 2 years, and we will start on another round of tax increases and service cutbacks. For New York City, at least, it is worse than retrenchment; it is a gradual but seemingly endless program of self-evisceration.

It seems to me inescapable, looking at our own financial position, that New York City and New York State are about to face once more an economic emergency of sizable dimension and indefinite duration.

I make these points to illustrate the utter futility for certain of our cities to try to cope with fundamental structural imbalances in a period

of inflation and recession. The situation of New York City may be extreme because of welfare and medicaid costs which crush the city's budget under a $1 billion burden. But fundamentally Chicago, Detroit, Philadelphia, and Washington, D.C., are no better off. Urban America is a meaningless term. Half of this country is prosperous and the other half decaying, with a domestic arc of crisis and decay stretching from Baltimore to Chicago.

Moreover, the process of decay cannot be isolated in the cities. Where urban centers struggle with automatic "budget gaps" fueled by revenue losses due to recession and longrun economic decline, and by high rates of inflation on the cost side, the corresponding States cannot be far behind. New York State provided the critical, first instance safety net for New York City in its fiscal crisis in 1975. New York State will face its own deficit in 1982 and cannot shoulder significant further burdens. We cannot assume that the relevant States will be capable of support as other cities experience severe fiscal difficulties.

The local actions which we are capable of taking—increased taxes and service reductions—intensify the downward spiral. Local taxes are inflationary and counterproductive. They add to the incentives for migration of people and investment to more favored areas. Deep service reductions have the same effect in the long run.

In the absence of some effective national action, State and local governments of the urbanized Northeast and Midwest face continued economic decline and stringent public sector "retrenchment" for the immediate and longer term future. This creates a continuous downward spiral.

In my judgment what is needed is first of all a recognition that different actions are needed for different regions. Once that is established I would recommend a program that would keep the Northeast and the Midwest viable.

The most important single thing the Federal Government can do to assist States and municipalities in fiscal difficulty is to begin solving the basis problems we are now encountering in the national economy: not only the general problems of inflation, declining competitiveness in international markets, energy and recession, but also the underlying structural problems, many of which are regional in origin or effect.

Solving these national economic problems will not be easy. I believe it requires measures, like a stiff gasoline tax to reduce energy consumption and create some of the revenues needed for positive economic action, which have not yet attained political support. But the greater danger in focusing on national problems is the temptation to adopt across-the-board measures like a general tax cut, in a mistaken attempt to be evenhanded.

Across-the-board stimulus may actually accelerate the trend of business away from our depressed areas. Given the real regional differences I have mentioned, any expenditure of national resources has to be deliberately targeted. This applies equally to direct expenditures of Federal dollars as well as to the economic stimulation that a tax cut is designed to produce.

In any specific program aimed at urban revitalization I would include:

One, changes in Federal formulas, mainly welfare and medicaid, so as to spread the burden of those costs to reflect need as well as ability

to pay. In addition, any programs which are mandated by Federal law and which add costs to already overburdened State and local budgets must be accompanied by sufficient Federal funds to carry out the mandate.

Two, exploration of programs to encourage local tax reduction with Federal participation. This could be done by having the Federal Government assume additional local costs in an amount equal to the fiscal dividend to the Federal budget created by local tax reduction. Local taxes are inflationary and a disincentive to business. Having the Federal Government support local tax reduction by reinvesting its fiscal benefits would give targeted stimulus at no budgetary cost.

Three, the immediate creation of an institution modeled after the Reconstruction Finance Corporation of the 1930's to provide a safety net and capital infusion for certain industries, financial institutions and municipalities in serious difficulties. Like all safety nets, it should be initiated before further disasters and not afterward. Too many large corporations are now seriously overleveraged; too many financial institutions are not nearly as strong as they should be; too many cities in dire straits.

The reconstruction of our older cities will have to take place alongside the restructuring of our basic industries. Like Siamese twins, the disease of one inevitably infects the other. As the industrial effort needed over the next two decades begins to take hold, a deliberate effort will have to be made to funnel private activity into the urban areas. A genuine partnership between business, labor, and government must create the industrial parks where private business will find it economical to produce, where the labor unions will commit to encourage minority entry and training, where the community leadership will involve itself and the local school system to become part of a process. A young black or Hispanic must be made to feel that he has a future if he stays in school off the street and out of trouble.

I am not competent to speak for other parts of the country, but I do know this. Just as the Western World is being bankrupted by a $200 billion per annum tax represented by our payments to OPEC, so this country will tear itself apart by internal shifts in wealth fully as dramatic. In that connection, however, we do have an advantage. We are negotiating with ourselves and we are all Americans.

For us in the Northeast it is futile to try to cope with long-term structural problems by taking short-term actions that will only exacerbate our ultimate situation. Increased taxes, layoffs, and reduced services in a time of inflationary recession will accentuate our regional downturn and drive more and more taxpayers away. There will come a point when the hemorrhage is not reversible.

It is for that reason that I have for the last 2 years called for a temporary wage-price freeze that, at the very least, would enable us to defer wage increases that, even though reasonable by current standards, are clearly beyond our capacity to pay. Such a freeze should stay in place until changes in national policies are made that would redress our structural imbalances. Short of such action at the Federal level, we will again be called upon to consider emergency action in the city and State of the type we instituted in 1975 at great pain and great cost to all our citizens.

There are unfortunately no easy or painless answers. It is even pos-

sible that there are no answers at all. Enormous amounts of capital will be needed to rebuild our older industries and cities, provide alternative sources of energy, and fuel the steady growth of our economy. This will require some shifts from consumption to production and new sources of revenues. A gasoline tax would clearly provide the revenues as well as helping the dollar by reducing oil imports. It may not be popular, but sooner or later it will have to happen.

Tax cuts, targeted to the areas of need and designed to encourage productive investment, would also help create capital. Finally, some of the capital will have to come from OPEC—recycling petrodollars on a long-term basis not just into bank accounts and real estate but into new production and jobs.

For us in the Northeast more of the same is slow death. We need recognition that basic changes have to occur, that Federal intervention is required and that this is a matter of enlightened self-interest for all. Our body social and politic cannot be immunized from the spreading cancer of our older regions.

Thank you.

Representative BOLLING. Thank you. Mr. Rohatyn, I would like to say briefly I initiated the Special Study on Economic Change because 4 years ago I agreed with virtually all of the things that you said. At least 90 percent. I have no reason to have changed my mind and I'm delighted that you're saying the same sort of thing and saying it repeatedly. I read some of your other statements and I think you present a very important public service, in particular coming from your particular business background.

Mr. ROHATYN. Thank you very much, Mr. Vice Chairman. It's very encouraging to hear these kinds of statements. Sometimes I think I'm boring everybody to death by saying the same thing over and over again.

Representative BOLLING. Not me. I'm afraid I might bore you.

Next, Ms. Donna Shalala.

STATEMENT OF DONNA E. SHALALA, ASSISTANT SECRETARY FOR POLICY DEVELOPMENT AND RESEARCH, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Ms. SHALALA. Thank you very much. First, let me compliment the committee, and particularly Mr. Bahl, for an absolutely first-class piece of work. I, like Mr. Rohatyn, would like to skip through my prepared statement and read parts of it and submit the entire prepared statement for the record.

I'm pleased to be here to discuss with you one of the most important problems facing our society—the fragile fiscal health of our Nation's urban areas. The most important point that I want to impress upon you is that the economic recession intensifies the existing fiscal problems of our major cities, and that national policy must continue to provide budgetary relief during economic downturns.

First, let me quickly answer the questions posed in your invitation to appear before this committee; then, in the remainder of my testimony, I will expand upon these answers.

Your first question concerns the fiscal outlook for State and local governments through the 1980's. Most of the economic forecasts agree

that economic growth will be relatively slow and that the economy will continue to be subject to periodic recessions. Simply stated, this means that the outlook for local governments during the 1980's is one of continued fiscal stress. Based on the experience of the last recession, we expect our larger cities to suffer the most severe fiscal hardship.

As you know, our urban areas exhibit great diversity. The administration's urban policy, the first national urban policy in our country's history, recognizes this diversity. As its preface says, "There is no single urban problem," and "no single simple solution." Yet the common plea of our State and local leaders is for a stable national economy as a setting to effect local policy. Without national economic stability, the work of local governments cannot be done properly; services cannot be delivered efficiently, and rational growth cannot be planned. Nor can we ease the problems caused by population and industrial decline or expand the employment and educational opportunities of the disadvantaged.

The point that I want to emphasize is that the ability of State and local governments, and most important cities, to adjust to longrun structural changes in the economy is constantly hampered by shortrun shifts in the Nation's business cycles. If we allow these shortrun changes to intensify, as is presently predicted for the 1980's, we can expect continued and increased fiscal stress at the local government level.

Your second question concerns recommendations for Federal, State, and local government policies and programs to help meet the needs of State and local governments in the 1980's. The single most important thing the Federal Government can do to meet the needs of State and local governments is to stabilize the national economy and return it to a path of uninterrupted economic growth.

Recession reduces the revenues of local governments and at the same time increases the demand for public services. When recession is coupled with rapid inflation, the results are even more dangerous to the financial health of local governments. Not only are revenues reduced by the recession, but the buying power of what is left is substantially less than what it otherwise would have been because of the inflation.

During periods of cyclical instability during the coming decade, the Federal Government should aim to insulate the State and local governments from cyclical changes. To accomplish this goal, Federal policy should emphasize continued general-purpose financial support such as that provided by revenue sharing. It should supplement that support with a permanent, highly targeted, antirecession fiscal assistance program, triggered to provide aid to cities at the onset of the economic downturn.

In answer to your third question, I believe that the various levels of government can, and in many cases do, work effectively together. In his national urban policy, President Carter stressed that to revitalize our urban areas we need to build a strong partnership between the three levels of government and the private sector. Our own urban development action grant—UDAG—program works to enhance that partnership by requiring private as well as public investment in each project.

As far as your fourth question is concerned, the present trend toward reducing the growth of Federal assistance to State and local governments will impose some additional fiscal burden on them. The burden

can be minimized, however, by stabilizing the national economy and targeting our programs more effectively to cities with the greatest fiscal difficulties. As the fiscal crisis spreads to more cities in the 1980's, we will inevitably need to target existing Federal resources.

Your final question concerns the proper role of Federal and State Governments vis-a-vis local governments. In my view, local governments have many administrative strengths. They deliver a vital set of services and can more easily tailor the level of those services to local public demands than Federal and State Governments can. But during periods of slow economic growth, exacerbated by periodic recessions and high rates of inflation, some local governments, particularly large cities, lack sufficient resources to finance the public services their residents require. Thus, the role of both the Federal and State Governments must be to provide fiscal relief to those cities facing the greatest financial hardship.

Before expanding upon these points, let me emphasize that the most recent data available suggest that cities are now in a much better financial position than they were at the beginning of 1976. At that time, the economy was just coming out of a major recession which had severely strained their fiscal capacity. In response to this critical situation, President Carter proposed and Congress enacted over $12 billion in economic stimulus aid programs for State and local governments. That package of programs gave our cities the economic boost needed to improve their fiscal position, and they began to climb toward financial recovery.

The President has also increased other resources available to cities to aid them in the recovery process. For example, through the urban development action grant program, which began in fiscal year 1978, HUD has awarded 766 grants totaling $1.4 billion. These grants have leveraged $8.4 billion of investment from the private sector.

The combination of increased Federal aid and economic recovery may have lulled us into believing that the fiscal crisis was behind us. But longrun secular trends affecting cities persisted despite national patterns of economic growth.

With this brief description in mind, I will now elaborate my brief answers to the committee's questions by reviewing now well-known major, long-term economic trends affecting our cities; by describing the implications of a serious recession coupled with these trends; and finally, by suggesting what might be done for our cities.

The secular changes experienced by older urban areas and their governments are part and parcel of the longrun structural changes in the economy as we shift to a more technological and service-oriented economy with fewer demands for manufacturing sections of the country. These changes too are the consequences of broad social preferences for decentralization aided by our expanding communications technology.

Let us not be mislead by the 1976–79 recovery. These trends continue today, and, in fact, are fueled by the current recession. Here is a point I wish to emphasize: The ability of State and local governments and, most importantly, of cities to adjust to longrun structural changes in the Nation's economy is constantly hampered by shortrun shifts in the Nation's business cycle. Business cycles aggravate the longrun structural differences between central cities and suburbans, and between declining and growing regions.

A growing body of research, evidenced by the findings of Kathryn Nelson and Clifford Patrick, 1975, indicates that central city employment declines both absolutely and relatively to suburban employment during recession; during recovery, it expands at a much slower rate. A study by Carol Jusenius and Larry Ledebur, 1977, found that during downswings in the Nation's economy, the Northern economy declined while the South held relatively steady; and other research shows that during recovery periods, greater business creation in the growing West and South contributed to the already healthier employment situations there.

Cyclical effects on local economies are soon reflected in local budgets. Recessions reduce revenue collections, so that local jurisdictions are forced to increase tax rates, reduce public employment, cut back on services, and cancel or delay capital construction. In addition, certain expenditures such as welfare and unemployment payments may have to be increased. These consequences, of course, further increase the competitive disadvantages of localities experiencing secular decline.

When the national economy grows rapidly, city tax revenues rise. When the national economy slows or enters a recession, local governments lose tax revenues—according to ACIR, nearly $5 billion was lost as a result of recession in 1975. The volatility of local revenues dependent on Federal aid and national growth represents a potentially serious problem for Federal urban policy.

If we are to understand the current urban fiscal crisis and respond with sensible Federal policies, it is essential to distinguish between long-term trends in city economic activity and short-term cyclical fluctuations. When trend and the cycle move in the same direction, as they did during the 1974–75 recession, the picture is quite clear. Urban governments entered that recession in a relatively strong financial position because of the then recent enactment of general revenue sharing. Before the recession was over, however, both the economic base and the financial situation of many major cities and counties deteriorated, and they required substantial help in the form of a massive increase in Federal aid. At the other end of the cycle, economic expansion and recovery improve the financial position of many local governments. But the long-term trends are not substantially altered, and a number of cities and counties remain economically depressed.

Urban governments are entering the current recession already fiscally burdened from both a lack of complete recovery from the last recession and the recent reductions in Federal aid. Their fiscal problem will not be exacerbated as we move through the current recession. Furthermore, the 1980s do not promise to be a period of rapid economic growth. The relatively slow grow of the economy implies that without a reassessment of the Nation's priorities toward cities, there will be less resources available to aid urban areas. Thus, Federal aid should be better targeted to cities with the most economic decline.

The most important single policy the Federal Government can pursue to help cities is to stabilize the national economy and return it to a path of economic growth.

During economic downturns, the Federal Government should aim to insulate the public sector of cities from cyclical changes. Enacting Federal policy for cities during each short-term cyclical fluctuation and ignoring long-term trends frequently leads to mismatched timing between Federal aid and urban need.

Often, countercyclical programs are not even passed until after the recession is over. As a result, many local governments simply add the additional funds to their cash balances. This situation thwarts both the Federal purpose in providing the funds and sound financial planning at the local level. As the national economy improves, rapid withdrawal of Federal recovery of a city or county does not necessarily keep pace with the withdrawal of the Federal funds, leading to financial disruption for local budgets.

Sound Federal policy must recognize both the long-term economic trends and the short-term cyclical aspects of the present urban fiscal situation. Guaranteed future fiscal relief during periods of recession stabilizes the future financial situation of urban places and assures them that future recession will not exacerbate their already fragile fiscal health.

The facts presented here have clearly demonstrated the fragile nature of the current budget position of local governments and their vulnerability to an economic slowdown. This vulnerability exists because many urban areas are experiencing long-term economic decline, including losses of people, jobs, and tax base. These long-term trends are currently being intensified by the deterioration of the national economy.

The dichotomy between the long-term decline and the short-term cyclical swings affecting city budgets, coupled with shrinking Federal resources for fiscal assistance, suggests two critical elements in a Federal approach to urban fiscal problems. One element is a strong general fiscal aid program such as revenue sharing that guarantees fiscal assistance to those cities suffering the most severely from secular urban decline. A second is a high target antirecession fiscal relief program which promises the stability needed to withstand recessions. The program would need to be in place so that financial relief can be provided when it is needed most. This policy would provide a much-needed fiscal safety net and significantly relieve some of the burdens a recession would otherwise impose on those people most heavily dependent on local public services.

If our cities are to navigate successfully the present recession with the least damage, such a two-pronged policy should be enacted without delay. But above all, the policy that will best serve cities is the pursuit of a stable macroeconomic climate characterized by steady, noninflationary economic growth.

Thank you.

Representative BOLLING. If we could just get Congress to do it.

[The prepared statement of Ms. Shalala follows:]

PREPARED STATEMENT OF DONNA E. SHALALA

I am pleased to be here today to discuss with you one of the most important problems facing our society—the fragile fiscal health of our nation's urban areas. The most important point that I want to impress upon you is that the economic recession intensifies the existing fiscal problems of our major cities, and that federal policy must continue to provide budgetary relief during economic downturns.

First let me quickly answer the questions posed in your invitation to appear before this Committee, then, in the remainder of my testimony, I will expand upon these answers.

Your first question concerns the fiscal outlook for State and local governments through the 1980's. Most of the economic forecasts agree that economic growth will be relatively slow and that the economy will continue to be subject to periodic recessions. Simply stated, this means that the outlook for local governments dur-

ing the 1980's is one of continued fiscal stress. Based on the experience of the last recession, I expect our larger cities to suffer the most severe fiscal hardship. These cities and the people living in them will bear a major financial burden generated by an unstable national economy. However, instability hurts both ways. An overheated, inflationary economy also takes its toll on cities.

As you know, our urban areas exhibit great diversity. The Administration's urban policy, the first national urban policy in our country's history, recognizes this diversity. As its preface says, "there is no single urban problem" and "no single simple solution." Yet the common plea of our state and local leaders is for a stable/national economy as a setting to effect local policy. Without national economic stability, the work of local governments cannot be done properly: services cannot be delivered efficiently, and rational growth cannot be planned. Nor can we ease the problems caused by population and industrial decline or expand the employment and educational opportunities of the disadvantaged.

The point that I want to emphasize is that the ability of state and local governments, and most important cities, to adjust to long-run structural changes in the economy is constantly hampered by short-run shifts in the nation's business cycle. If we allow these short-run changes to intensify, as is presently predicted for the 1980's, we can expect continued and increased fiscal stress at the local government level.

Your second question concerns recommendations for Federal, state, and local government policies and programs to help meet the needs of state and local governments in the 1980's. The single most important thing that the Federal government can do to meet the needs of state and local governments is to stabilize the national economy and return it to a path of uninterrupted economic growth.

Recession reduces the revenues of local governments and at the same time increases the demand for public services. When recession is coupled with rapid inflation, the results are even more dangerous to the financial health of local governments. Not only are revenues reduced by the recession, but the buying power of what is left is substantially less than what it otherwise would have been because of the inflation. Stabilizing the national economy is the most important Federal urban policy for the 1980's.

During periods of cyclical instability during the coming decade, the Federal government should aim to insulate the state and local governments from cyclical changes. To accomplish this goal, Federal policy should emphasize continued general-purpose financial support such as that provided by revenue sharing. It should supplement that support with a permanent, highly targeted, anti-recession fiscal assistance program, triggered to provide aid to cities at the onset of the economic downturn.

In answer to your third question, I believe that the various levels of government can, and in many cases do, work effectively together. In his National Urban Policy, President Carter stressed that to revitalize our urban areas we need to build a strong partnership between the three levels of government and the private sector. Our own Urban Development Action Grant (UDAG) program works to enhance that partnership by requiring private as well as public investment in each project. Using such cooperative relationships, the various levels of government and the private sector can effectively work together to deliver much needed public services and improve the fiscal health of our cities.

As far as your fourth question is concerned, the present trend toward reducing the growth of Federal assistance to state and local governments will impose some additional fiscal burden on them. The burden can be minimized, however, by stabilizing the national economy and targeting our programs more effectively to cities with the greatest fiscal difficulties. As the fiscal crisis spreads to more cities in the 1980's, we will inevitably need to target existing Federal resources, more exactly, to examine more carefully the service delivery methods of local governments, and to discuss at greater length of the appropriate functions of the various levels of government.

Your final question concerns the proper role of Federal and state governments vis-a-vis local governments. In my view, local governments have many administrative strengths. They deliver a vital set of services and can more easily tailor the level of those services to local public demands than Federal and state government can. But during periods of slow economic growth, exacerbated by periodic recessions and high rates of inflation, some local governments, particularly large cities, lack sufficient resources to finance the public services their residents require. Thus the role of both the Federal and state governments must be to provide fiscal relief to those cities facing the greatest financial hardship.

Before expanding upon these points, let me emphasize that the most recent data available suggest that cities are now in a much better financial position than they were at the beginning of 1976. At that time, the economy was just coming out of a major recession which had severely strained their fiscal capacity. In response to this critical situation, President Carter proposed and Congress enacted over $12 billion in economic stimulus aid programs for state and local governments. That package of programs gave our cities the economic boost needed to improve their fiscal position, and they began the climb toward financial recovery.

The President has also increased other resources available to cities to aid them in the recovery process. For example, through the Urban Development Action Grant Program (UDAG), which began in fiscal year 1978, HUD has awarded 766 grants totaling $1.48 billion. These grants have leveraged $8.42 billion of investment from the private sector. These grants are made for economic development projects in large and small distressed cities and are balanced among commercial, industrial, and neighborhood projects.

The Community Development Block Grant (CDBG) program enables communities to choose their own strategies to improve housing quality, revitalize and redevelop neighborhoods, and improve local services especially for low- and moderate-income households. During fiscal year 1976, $2.75 billion was appropriated for the program. This appropriation was increased to over $3.8 billion for fiscal year 1980.

The combination of increased Federal aid and economic recovery may have lulled us into believing that the fiscal crisis was behind us. But long-run secular trends affecting cities persisted despite national patterns of economic growth.

After four years of economic growth we are again in a recession. This recession comes at a time when many of our major cities have not yet fully recovered from the 1974–75 economic downturn. As a result, they lack the financial cushion that was available to many of them as they entered the 1974–75 recession and which is necessary to weather the problems associated with a national economic decline. The nationwide unemployment rate reached 7.8 percent in May. The unemployment rate for Detroit in March was 15 percent, and 929,000 experienced construction workers are without jobs. If the recession's effects on the finances of local governments follow changes in the national economy as they did during 1974–75, then cities have yet to feel the full fiscal impact of the present economic situation.

In addition, the current recession will reinforce the circumstances which continue to generate long-term urban decline—loss of jobs, people, and economic base. Cities with older physical plants, higher proportions of the poor and elderly, and higher crime rates are still experiencing relatively more economic decline than their surburban counterparts and the nation as whole. The poor and the low-skilled remain in the urban core, while the richer, upwardly mobile part of the population continues to move to the suburbs. Local government efforts to reduce services or increase taxes in a fiscal crisis lead to further deterioration of the business climate and to an increased out-migration of the mobile part of the population. Such responses to crisis also place a heavy burden on low-income households: they are most likely to be dependent on public services and they cannot afford to move.

We are not alone in our concerns for the fiscal viability of our cities. A report prepared for the Joint Economic Committee and released April 20, 1980, draws the following conclusions about the fiscal conditions of cities:

Despite the fact that the period under study (1978–1979) was one of economic recovery, cities, generally, have not flourished. An increasing proportion of cities experienced operating deficits in 1978 and 1979, a trend which is projected to continue in 1980.

With this brief description in mind, I will now elaborate my brief answers to the Committee's questions by reviewing now well-known major, long-term economic trends affecting our cities; by describing the implications of a serious recession coupled with these trends; and finally by suggesting what might be done for our cities.

FISCAL OUTLOOK AND LONG-TERM ECONOMIC TRENDS

The Past Decade

To address the fiscal outlook for cities during the 1980's, we should review the economic trends in cities. The 1970's proved to be one of the more economically volatile periods in our nation's history. During this period we witnessed the worst recession since World War II. Economic issues—price inflation, tax revolts, unemployment—dominated the public agenda. Financial markets were

uneasy; interest rates soared. Problems in the markets for energy and housing forever altered deeply held American beliefs about our national independence and about such quality-of-life issues as homeownership that is now a long-cherished social institution in which many Americans are no longer confident of participating.

It was also in the 1970's that public attention focused on the financial problems of local government, dramatically so with the near default of our nation's largest city. But striking as these examples are, the fiscal problems of local governments are not confined to the New Yorks and Clevelands. Serious problems exist around the country for smaller cities too, and for older suburbs, counties, and townships large and small. The projections of this Committee contained in your "Midyear Report" suggest that the 1980's will offer small relief from this continuously deteriorating condition.

Secular Decline

A number of different measures have been used to assess the health and longer-term prospects of urban areas (tables attached). The ones I use here, trends in population, income, and employment, document the basic long-term trend in urban decline.[1] These measures are not very responsive to cyclical changes in economic activity; thus they are very important in gauging long-term trends. Their actual relationship to fiscal condition varies, but it is clear that downturns in these measures signal increased financial pressure and distress.

Although the data presented here are primarily for large central cities, and in many cases only over the period to 1976–77, the trends they document are equally applicable to many smaller cities and counties, including some older suburban areas.

Population

This is a familiar and often-used measure of community condition. Population loss places a special burden on urban governments by magnifying budgetary strain, because while a loss of population rapidly depletes taxable resources, essential public expenditures do not drop proportionally. Furthermore, it is the better-educated, higher-income households who are leaving the urban core, so the impact on the economy is even greater.

Population change affects almost all revenue sources, including property tax revenues (the major source for most cities) and local sales and income taxes (which are partially borne by commuters and shoppers living outside the central jurisdictions). In general, a loss in population implies a future loss in local tax revenues.

The following population trends illustrate the situation quite clearly:

The population of central cities as a group declined by 4.6 percent from 1970 to 1977 while the suburban population increased by 12 percent.—(Table 1) Large central cities experienced even greater losses during this period, declining by 7.1 percent as a group.

A number of large central cities that grew between 1960 and 1970, have lost population since 1970.—(Table 2) This group includes Denver and Los Angeles, cities in the Western region of the country, indicating that central city decline is a national phenomenon with implications for more than a few crisis areas. Among large cities that have declined steadily since 1960, the most rapidly declining cities are Cleveland, Minneapolis, and St. Louis, with Buffalo, Detroit, and Pittsburgh close behind. New Orleans and San Francisco are also in the category of cities that have steadily lost population since 1960.

The loss of central city population between 1970 and 1977 is symptomatic of the long-run trend in the loss of central city dominance over SMSA's, which extends as far back as 1900 in a number of urban areas.—(Table 3) Washington, D.C., for example, accounted for more than two-thirds of the population in its metropolitan area in 1930, but less than one-fourth of it by 1976. Most other major cities experienced similar declines in relative importance. This is an indication of the extent to which the central city is able to capture the tax base of newer and generally wealthier outlying parts of its metropolitan area. Annexation has enabled a number of central cities to capture portions of their suburban tax base and is reflected in the extent of their dominance of their SMSA. Annexation, however, has been confined almost exclusively to the Southern and Western regions of the nation in recent years; a few Midwest cities have annexed, but no annexation at all has occurred in the Northeast.

[1] A recent study by Richard Nathan of Princeton University reinforces this conclusion.

Within the same SMSA, from March 1975 to March 1978 more than twice as many people moved from the central city to the suburbs as from the suburbs to the central city.—(Table 4) The back-to-the-city movement is clearly overwhelmed by the continuing exodus from central cities.

Income

The income level of cities is another useful indicator of fiscal condition. It is related to a variety of revenue sources, including local income, sales, and property taxes. Trends in central city income are indicated by the following:

From 1969 to 1977 the real dollar median income of families living in central cities fell by $573 while the income of their suburban counterparts rose by $633.—(Table 5) In 1969, the median suburban family earned $2,761 more than the city dweller. By 1977, the suburban family earned $3,967 more than the city family. Not only did city dwellers lose income, but they also lost relative to families living in the suburbs.

Between 1960 and 1975, the ratio of central city to suburban per capita income declined in 73 of the nation's 82 largest metropolitan areas.—(Table 6) This trend was clear in all four regions of the nation. More than 83 percent of these large cities in the East, 86 percent of those in the Midwest, 88 percent of those in the South, and 100 percent of those in the West exhibited declines in this ratio.

In addition to median and per capita levels, another important dimension of incomes in central cities is the fraction of the population with very low incomes. Two measures illustrate the extra fiscal burden on central cities: percent of the population below the poverty level, and transfer payments as a share of local income.

A larger fraction of the poverty population of the U.S. lived in central cities in 1976 than in 1970.—(Table 7) During this period, both suburban and nonmetropolitan areas experienced reductions in the percent of their population below the poverty level while this percent rose in central cities.

Transfer payments constituted a larger share of local income in declining counties than in growing counties in 1975.—(Table 8) This share also grew faster between 1970 and 1975 in these declining cities. Several growing cities (Phoenix, San Antonio and San Diego), have relatively high percentages, but this is generally attributed to retired people (civilian and military) who represent a smaller drain on public resources. The high percentages in Boston (31.7 percent), Philadelphia (27.0 percent), St. Louis (28.0 percent) and New York (25.0 percent) highlight an incerasing reliance on government programs to sustain the local economy.

Employment

A final indicator of long-term decline and fiscal pressure is city employment. Employment affects virtually all potential tax bases in one way or another. Just how much a particular city will be affected by job loss depends on its tax structure and on the mix of jobs in its economy. One problem facing many older cities is that service sector and public sector jobs replacing manufacturing job losses do not generally produce equivalent tax yields. Roy Bahl, Alan K. Campbell, and David Greytak have estimated that in terms of tax revenues, New York City requires 1.11 service jobs or 1.61 government jobs to replace one manufacturing job. The trends in central city employment are indicated by the following:

Employment of central city residents declined by 1.4 percent between 1970 and 1977 while employment of suburban and nonmetropolitan residents increased by 25.1 percent.—(Table 9) The employment of central city females actually increased during this period, but it was more than offset by the decline in male employment.

Unemployment was higher among central city residents in 1970, and rose by a larger amount between 1970 and 1976, than unemployment in suburban or nonmetropolitan areas. This relationship appears to be a secular trend.

CYCLICAL DECLINE: RECESSION

For some time economists and urbanists have been aware of the local fiscal impacts of intra-regional and inter-regional shifts of population and employment. As people and jobs have moved across and out of metropolitan areas, particularly in the older and colder parts of the country, local general-purpose city governments have been burdened with maintaining traditional levels of service in the face of a declining tax base. The burden is of course greater where a larger

proportion of the population is poor and elderly, where crime rates are high, and where the localities' capital and physical plants are old and deteriorating.

The secular changes experienced by older urban areas and their governments are part and parcel of the long-run structural changes in the economy as we suift to a more technological and service-oriented economy with fewer demands for manufacturing workers and for unskilled laborers who are concentrated in the older manufacturing sections of the country. These changes too are the consequences of broad social preferences for decentralization aided by our expanding communications technology.

Let us not be mislead by the 1976–79 recovery. These trends continue today, and in fact are fueled by the current recession. Here is a point I wish to emphasize: the ability of state and local government and, most importantly, of cities to adjust to long-run structural changes in the nation's economy is constantly hampered by short-run shifts in the nation's business cycle. Business cycles aggravate the long-run structural differences between central cities and suburbs, and between declining and growing regions.

A growing body of research, evidenced by the findings of Kathryn Nelson and Clifford Patrick (1975), indicates that central city employement declines both absolutely and relatively to surburban employment during recession; during recovery, it expands at a much slower rate. A study by Carol Jusenius and Larry Ledebur (1977) found that during downswings in the nation's economy, the Northern economy declined while the South held relatively steady; and other research shows that during recovery periods greater business creation in the growing West and South contributed to the already healthier employment situations there.

Cyclical effects on local economies are soon reflected in local budgets. Recessions reduce revenue collections, so that local jurisdictions are forced to increase tax rates, reduce public employment, cut back on services, and cancel or delay capital construction. In addition, certain expenditures such as welfare and unemployment payments may have to be increased. These consequences, of course, further increase the competitive disadvantages of localities experiencing secular decline.

When the national economy grows rapidly, city tax revenues rise. When the national economy slows or enters a recession, local governments lose tax revenues—according to ACIR, nearly $5 billion was lost as a result of recession in 1975. The volatility of local revenues dependent on federal aid and national growth represents a potentially serious problem for federal urban policy.

Let me now provide you with some specific information on the present condition of our cities and, given that present condition, the likely impacts of this recession.

GNP and Urban Fiscal Health

The national economic trends in GNP and employment from 1970 to 1978 show a clear relationship to urban fiscal health.—(Figure 1) The slowest growth in GNP occurred in 1974 and 1975, the worst years for the budgets of large cities. National employment also had its slowest growth in those two years. This point is well illustrated in Figure 1, which shows the trends in these national economic indicators along with city budget data. The four trends show the same pattern with only slight deviations in timing. Declines in real GNP and employment are soon followed by declines in cities' own source revenues and increased budget deficits. Real GNP and employment are declining.

Unemployment

Central cities characteristically have higher unemployment rates during recession than the nation as a whole.—Table 10 illustrates pronounced and prolonged unemployment in big cities over the 1974–75 recession and 1975–79 recovery period. The most recent rate available is for March 1980. Given that the rate for cities has generally been higher than the national average, we can expect the May rate to exceed 7.8 percent in many large cities.

Local Budgets

As your own report entitled "Trends in Fiscal Conditions of Cities 1978–1980" suggests, recent evidence indicates that *for many cities expenditures are growing much more rapidly than revenues* (Table 11). This rapid increase in expenditures is partly the result of spending deferred from the last recession. Expenditures which have been deferred will utimately need to be made to maintain a viable city operation. In addition, *decreases in*

past year capital expenditures have frequently been deferred to adjust for revenue shortfalls, leaving a situation in which capital expenditures may be deferred in the future only at the risk of physical collapse. Our own study of the capital plant needs of selected cities agrees that the risk of further central city decline from continued capital expenditures deferment is very high.

Revenue Sources

Many cities are moving away from sole reliance on the property tax to greater reliance on other taxes, specifically the sales tax and uses changes (Table 12). This increased reliance on the more cyclically sensitive types of taxation renders cities more vulnerable to the present recession.

Federal Aid

Federal aid to cities has tapered off and is rapidly declining in real terms, a trend not likely to be reversed in the near future (Table 12). Unfortunately, *because much of the increase in Federal aid cities since 1976 has been based on needs generated by the short-term cyclical changes* in the economy rather than on long-term trends and has by now been terminated, *such a policy has made cities to some extent dependent for aid upon unstable swings in the business cycle rather than upon a more stable Federal effort to ameliorate the long-term decline.*

THE TREND AND THE CYCLE

If we are to understand the current urban fiscal crisis and respond with sensible federal policies, it is essential to distinguish between long-term trends in city economic activity and short-term cyclical fluctuations. When trend and the cycle move in the same direction, as they did during the 1974–75 recession, the picture is quite clear. Urban governments entered that recession in a relatively strong financial position because of the then recent enactment of General Revenue Sharing. Before the recession was over, however, both the economic base and the financial situation of many major cities and counties deteriorated, and they required substantial help in the form of a massive increase in federal aid. At the other end of the cycle, economic expansion and recovery improve the financial position of many local governments. But the long-term trends are not substantially altered, and a number of cities and counties remain economically depressed.

Urban governments are entering the current recession already fiscally burdened from both the lack of complete recovery from the last recession and the recent reductions in federal air. Their fiscal problem will now be exacerbated as we move through the current recession. Furthermore, the 80's do not promise to be a period of rapid economic growth. The relatively slow growth of the economy implies that without a reassessment of the nation's priorities toward cities there will be less resources available to aid urban areas. Thus Federal aid should be better targeted to cities with the most economic decline.

POLICY IMPLICATIONS

The most important single policy the Federal government can pursue to help cities is to stabilize the national economy and return it to a path of economic growth.

During economic downturns, the Federal government should aim to insulate the public sector of cities from cyclical changes. Enacting federal policy for cities during each short-term cyclical fluctuation and ignoring long-term trends frequently leads to mismatched timing between federal aid and urban need. Often, countercyclical programs are not even passed until after the recession is over. As a result, many local governments simply add the additional funds to their cash balances. This situation thwarts both the federal purpose for providing the funds and sound financial planning at the local level. As the national economy improves, rapid withdrawal of federal aid may again lead to fiscal stress because in many cases the financial recovery of a city or county does not necessarily keep pace with the withdrawal of the federal funds, leading to financial disruption for local budgets.

Sound federal policy must recognize both the long-term economic trends and the short-term cyclical aspects of the present urban fiscal situation. Guaranteed future fiscal relief during periods of recession stabilizes the future financial situation of urban places and assures them that future recession will not exacerbate their already fragile fiscal health.

The facts presented here have clearly demonstrated the fragile nature of the current budget position of local governments and their vulnerability to an economic slowdown. This vulnerability exists because many urban areas are experiencing long-term economic decline, including losses of people, jobs, and tax base. These long-term trends are currently being intensified by the deterioration of the national economy.

The dichotomy between the long-term decline and the short-term cyclical swings affecting city budgets, coupled with shrinking federal resources for fiscal assistance, suggests two critical elements in a federal approach to urban fiscal problems. One element is a strong general fiscal aid program such as Revenue Sharing that guarantees fiscal assistance to those cities suffering the most severely from secular urban decline. A second is a highly targeted anti-recession fiscal relief program which promises the stability needed to withstand recessions. The program would need to be in place so that financial relief can be provided when it is needed most. This policy would provide a much-needed fiscal safety net and significantly relieve some of the burdens a recession would otherwise impose on those people most heavily dependent on local public services.

If our cities are to navigate successfully the present recession with the least damage, such a two-pronged policy should be enacted without delay. But above, all, the policy that will best serve cities is the pursuit of a stable macroeconomic climate characterized by steady, non-inflationary economic growth.

TABLE 1.—CENTRAL CITY, SUBURBAN AND NONMETROPOLITAN POPULATION: 1970 AND 1977

[Numbers in thousands, 1970 metropolitan area definition]

Type of residence	1970	1977	Percent change 1970 to 1977
United States	199, 819	212, 566	6.4
Metropolitan areas	137, 058	143, 107	4.4
Central cities	(62, 876)	(59, 993)	(−4.6)
Suburban areas	(74, 182	(83, 114)	(12.0)
Metropolitan areas of 1,000,000 or more	78, 489	82, 367	3.6
Central cities	(34, 322)	(31, 898)	(−7.1)
Suburban areas	(45, 166)	(50, 469)	(11.7)

Source: U.S. Bureau of the Census, "Social and Economic Characteristics of the Metropolitan and Nonmetropolitan Population: 1977 and 1970," Current Population Reports, P-23, No. 75, November 1978.

TABLE 2.—POPULATION GROWTH IN SELECTED LARGE CITIES, 1960, 1970, 1975, AND 1977

City	Population (thousands)			Percent change	
	1960	1970	1977	1960–70	1970–77
Growing:					
Houston	938	1, 233	1, 555	31	26
Memphis	497	624	668	26	7
Phoenix	439	582	684	33	18
San Antonio	588	654	793	11	21
San Diego	574	697	800	22	15
Formerly growing, now declining:					
Columbus, Ohio	471	540	532	15	−1
Denver	494	515	475	4	−8
Indianapolis	476	745	705	57	−5
Jacksonville	201	529	528	163	0
Kansas City	476	507	459	7	−9
Los Angeles	2, 479	2, 816	2, 761	14	−2
Declining:					
Baltimore	939	906	804	−4	−11
Boston	697	641	618	−8	−4
Buffalo	533	465	390	−13	−16
Chicago	3, 550	3, 367	3, 063	−5	−9
Cincinnati	503	453	403	−10	−11
Cleveland	876	751	609	−14	−19
Detroit	1, 670	1, 511	1, 290	−10	−15
Milwaukee	741	717	653	−3	−9
New Orleans	628	593	561	−6	−5
Philadelphia	2, 003	1, 949	1, 778	−3	−7
Pittsburgh	604	520	442	−14	−19
St. Louis	750	622	518	−17	−17
San Francisco	740	716	655	−3	−9
Minneapolis	483	434	360	−10	−17
New York	7, 782	7, 895	7, 298	1	−8

Source: George Peterson et al., "Urban Fiscal Monitoring," forthcoming.

TABLE 3.—CENTRAL CITY AREA POPULATION AS A PROPORTION OF TOTAL SMSA POPULATION 1900, 1930, 1960, 1970, 1976

[1 equals total SMSA population]

Region and SMSA	1900	1930	1960	1970	1976
East:	0.80	0.69	0.46	0.40	0.35
Bridgeport	.52	.52	.29	.23	.20
Hartford	.67	.68	.36	.26	.24
Washington, D.C.	.70	.75	.52	.43	.39
Baltimore	.42	.36	.26	.23	.23
Boston	.67	.66	.58	.52	.51
Springfield [1]	.65	.71	.56	.51	.48
Worcester	.53	.45	.45	.42	.42
Jersey City	.47	.35	.23	.20	.19
Newark	.53	.37	.23	.20	.21
Paterson [1]	.47	.56	.42	.35	.33
Albany [1]	.63	.62	.40	.34	.30
Buffalo	.90	.86	.72	.68	.66
New York	.48	.60	.43	.33	.29
Rochester	.38	.52	.38	.30	.28
Syracuse	.68	.62	.46	.40	.37
Philadelphia	.41	.33	.25	.21	.19
Pittsburgh	.57	.48	.43	.37	.36
Providence [1]					
Midwest:	.81	.75	.57	.50	.44
Chicago	.53	.78	.69	.63	.64
Fort Wayne	.33	.77	.60	.52	.48
Gary [1]	.47	.63	.51	.67	.62
Indianapolis	.75	.82	.78	.70	.65
Des Moines	.37	.64	.66	.71	.68
Wichita	.66	.72	.44	.35	.32
Detroit	.18	.65	.47	.38	.33
Flint	.51	.57	.38	.36	.33
Grand Rapids	.79	.83	.53	.41	.35
Minneapolis—St. Paul	.47	.57	.43	.40	.36
Kansas City	.67	.57	.35	.26	.22
St. Louis	.53	.68	.65	.64	.64
Omaha	.43	.65	.47	.40	.37
Akron	.52	.53	.39	.32	.30
Cincinnati	.76	.69	.55	.36	.32
Cleveland	.57	.70	.62	.58	.56
Columbus	.37	.52	.36	.28	.24
Dayton	.53	.64	.50	.55	.52
Toledo	.43	.58	.44	.37	.35
Youngstown [1]	.27	.51	.57	.59	.55
Madison	.70	.70	.57	.51	.47
Milwaukee					
South:	.21	.50	.47	.40	.37
Birmingham	.53	.46	.53	.50	.48
Mobile	.71	.83	.44	1.00	1.00
Jacksonville	.80	.77	.31	.26	.24
Miami	.33	.65	.59	.48	.41
Tampa—St. Petersburg	.45	.58	.47	.35	.28
Atlanta	.28	.45	.53	.64	.71
Columbus	.69	.73	.53	.43	.40
Louisville	.35	.45	.66	.58	.94
Baton Rouge	.89	.87	.69	.56	.51
New Orleans	.23	.50	.58	.51	.60
Shreveport	.10	.45	.65	.59	.65
Jackson	.32	.64	.63	.58	.64
Charlotte	.17	.67	.63	.57	.53
Oklahoma City		.47	.62	.69	.66
Tulsa	.29	.50	.30	.43	.43
Knoxville	.60	.74	.73	.08	.84
Memphis	.6	.69	.38	.82	.75
Nashville	.46	.67	.88	.85	.87
Austin	.38	.36	.63	.71	.72
Corpus Christi					

See footnotes at end of table.

TABLE 3.—CENTRAL CITY AREA POPULATION AS A PROPORTION OF TOTAL SMSA POPULATION 1900, 1930, 1960 1970 and 1976—Continued

[1 equals total SMSA population]

Region and SMSA	1900	1930	1960	1970	1976
Dallas	.16	.51	.60	.54	.49
ElPaso	.64	.77	.88	.89	.91
Fort Worth	.31	.70	.62	.51	.45
Houston	.37	.63	.66	.62	.60
San Antonio	.58	.72	.82	.75	.81
Norfolk [1]	.50	.76	.72	.61	.54
Richmond	.55	.71	.50	.48	.41
West:					
Phoenix	.28	.31	.66	.60	.56
Tucson	.88	.58	.80	.74	.67
Anaheim [1]	.30	.34	.40	.31	.28
Fresno	.32	.36	.36	.40	.40
Los Angeles—Long Beach	.61	.62	.46	.45	.44
Sacramento	.38	.49	.30	.31	.29
San Bernardino [1]	.16	.22	.14	.11	.10
San Diego	.51	.70	.55	.51	.49
San Francisco—Oakland	.78	.70	.41	.34	.32
San Jose	.36	.40	.31	.41	.48
Denver	.72	.74	.53	.41	.34
Honolulu	.67	.67	.58	.51	1.00
Albuquerque	.21	.58	.76	.77	.77
Portland	.60	.66	.45	.37	.35
Salt Lake City	.62	.67	.42	.31	.26
Seattle [1]	.60	.67	.50	.41	.38
Spokane	.63	.76	.65	.59	.57
Tacoma	.67	.65	.45	.37	.36

[1] Contains multiple central cities. Populations of all the central cities are contained in the numerator.

Source: ACIR, Trends in Metropolitan America; 1976 data from U.S. Bureau of the Census, "Current Population Reports."

TABLE 4.—MIGRATION BETWEEN CENTRAL CITY AND SUBURBS WITHIN SMSA'S, 1975–78

	All races			Blacks			Spanish origin		
	Total	Male	Female	Total	Male	Female	Total	Male	Female
Central city to balance of SMSA	4,640	2,296	2,344	546	250	296	406	191	215
Balance of SMSA to central city	2,231	1,108	1,124	261	129	132	154	70	84
Net migration ratio	2.08	2.07	2.09	2.09	1.9	2.24	2.64	2.73	2.56

Source: U.S. Bureau of the Census, "Current Population Reports: Geographic Mobility, March 1975 to March 1978."

TABLE 5.—CENTRAL CITY AND SURBURBAN MEDIAN FAMILY INCOMES, 1969 AND 1977

[In 1977 dollars, 1970 metropolitan area definition]

Sex and race of family head	Median income in 1969			Median income in 1977		
	Central cities	Surburban areas	Nonmetropolitan areas	Central cities	Surburban areas	Nonmetropolitan areas
All families (total)	$15,506	$18,267	$12,701	$14,933	$18,900	$13,789
White	16,608	18,536	13,206	16,286	19,210	14,403
Black	10,845	11,438	6,552	9,610	13,023	7,512
Families with female head (total)	8,075	9,954	7,413	7,210	9,328	6,824
White	9,596	10,477	7,225	8,643	10,087	7,759
Black	5,848	5,775	4,091	6,013	5,733	8,798

Source: Current Population Report, Series P-60, No. 118, March 1979.

TABLE 6.—PER CAPITA INCOME, CENTRAL CITY AND OUTSIDE CENTRAL CITY AREAS, 1960 AND 1975

Region and SMSA	1960			1975		
	Central city	Outside central city	Ratio of central city to outside central city	Central city	Outside central city	Ratio of central city to outside central city
EAST						
Bridgeport	$1,967	$2,613	0.75	$4,424	$5,717	0.77
Hartford	2,104	2,521	.83	3,997	5,828	.69
Washington, D.C	2,406	2,432	.98	5,659	6,712	.84
Baltimore	1,866	2,063	.90	4,330	5,442	.80
Boston	1,919	2,363	.81	4,157	5,257	.79
Springfield [1]	1,888	2,078	.90	4,145	4,765	.87
Worcester	1,935	1,901	1.01	4,435	4,645	.95
Jersey City	1,963	2,107	.93	4,298	4,672	.92
Newark	1,792	2,747	.65	3,348	6,128	.55
Paterson [1]	2,053	2,646	.77	3,699	6,285	.59
Albany [1]	1,985	1,989	.99	4,748	4,842	.98
Buffalo	1,913	2,113	.90	3,928	4,712	.83
New York	2,306	2,734	.84	4,939	5,867	.88
Rochester	2,072	2,259	.91	4,335	5,423	.80
Syracuse	2,152	1,922	1.11	4,123	4,551	.91
Philadelphia	1,875	2,272	.82	4,330	5,211	.83
Pittsburgh	1,943	1,945	.99	4,426	4,739	.93
Providence [1]	1,843	1,823	1.01	4,314	4,564	.95
Mean	1,999	2,251	.90	4,346	5,298	.82
MIDWEST						
Chicago	2,293	2,662	.86	4,689	5,977	.78
Fort Wayne	2,105	1,957	1.07	4,661	5,192	.98
Gary [1]	1,824	2,022	.90	4,038	5,180	.78
Indianapolis	2,031	2,179	.93	4,843	5,323	.91
Des Moines	2,296	2,035	1.08	4,975	5,434	.91
Wichita	2,082	1,896	1.09	4,951	4,454	1.11
Detroit	2,005	2,261	.88	4,462	5,715	.78
Flint	2,045	1,721	1.18	4,449	4,525	.98
Grand Rapids	1,937	1,943	.99	4,463	4,589	.97
Minneapolis	2,246	2,178	1.03	5,063	5,400	.94
Kansas City	2,176	2,105	1.03	4,736	5,261	.90
St. Louis	1,801	2,192	.82	4,006	5,245	.76
Omaha	2,139	1,846	1.15	4,877	4,432	1.10
Akron	2,124	2,012	1.05	4,614	4,923	.94
Cincinnati	2,043	2,031	1.00	4,517	4,684	.96
Cleveland	1,856	2,693	.68	3,925	5,722	.69
Columbus	1,885	2,310	.81	4,333	5,169	.84
Dayton	1,973	2,127	.92	4,091	5,015	.82
Toledo	2,012	2,009	1.00	4,571	5,076	.90
Youngstown [1]	1,787	1,936	.96	4,181	4,772	.88
Madison	2,214	1,873	1.18	4,885	5,032	.98
Milwaukee	2,105	2,305	.91	4,680	5,628	.83
Mean	2,049	2,104	.98	4,562	3,123	.90
SOUTH						
Birmingham	1,570	1,347	1.16	4,023	4,650	.87
Mobile	1,747	1,101	1.58	3,814	3,720	1.02
Jacksonville	1,611	1,814	.88	4,615	(2)	(2)
Miami	1,838	2,101	.87	4,416	5,750	.77
Tampa [1]	1,798	1,724	1.04	4,625	5,017	.92
Atlanta	1,934	1,918	1.00	4,527	5,664	.80
Columbus	1,534	1,297	1.19	4,215	3,241	1.30
Louisville	1,764	1,946	.90	4,302	4,926	.87
Baton Rouge	1,855	1,493	1.24	4,187	4,361	(2)
New Orleans	1,740	1,673	1.03	4,029	4,361	.92
Shreveport	1,859	1,307	1.42	4,086	3,365	1.21
Jackson	1,756	921	1.90	4,514	3,335	1.35
Charlotte	1,975	1,443	1.36	5,007	3,804	1.32
Oklahoma City	1,981	1,850	1.07	4,731	4,531	1.05
Tulsa	2,298	1,560	1.47	5,173	4,007	1.29
Knoxville	1,486	1,570	.94	4,044	4,393	.92
Memphis	1,651	1,220	1.35	4,383	4,033	1.09
Nashville	1,288	1,934	1.66	4,606	4,727	.97
Austin	1,688	1,520	1.11	4,379	4,658	.94
Corpus Christi	1,616	1,122	1.44	3,941	3,051	1.29
Dallas	2,219	1,906	1.16	5,285	4,932	1.07
El Paso [1]	1,579	1,405	1.12	3,479	2,854	1.22
Fort Worth	1,946	1,782	1.09	4,527	4,742	.95
Houston	2,062	1,735	1.18	5,110	5,079	1.01
San Antonio	1,427	1,937	.73	3,601	4,971	.72
Norfolk	1,718	1,613	1.07	4,233	4,509	.94
Richmond	1,940	2,055	.94	4,952	5,397	.92
Mean	1,771	1,603	1.14	4,411	4,354	1.04

See footnotes 1, 2, p. 51.

TABLE 6.—PER CAPITAL INCOME, CENTRAL CITY AND OUTSIDE CENTRAL CITY AREAS, 1960 AND 1975—Continued

Region and SMSA	1960			1975		
	Central city	Outside central city	Ratio of central city to outside central city	Central city	Outside central city	Ratio of central city to outside central city
WEST						
Phoenix	2,013	1,741	1.15	4,942	4,933	1.00
Tuscon	1,886	1,942	.97	4,385	5,159	.85
Anaheim [1]	2,138	2,361	.90	4,706	5,842	.81
Fresno	1,984	1,702	1.16	4,243	4,147	1.02
Los Angeles [1]	2,603	2,453	1.06	5,318	5,252	1.01
Sacramento	2,476	2,069	1.19	4,765	4,850	.98
San Bernardino [1]	2,103	1,812	1.16	4,386	4,408	1.00
San Diego	2,301	2,054	1.12	5,016	4,633	1.08
San Francisco [1]	2,596	2,516	1.03	5,672	6,066	.93
San Jose	2,205	2,390	.92	4,970	6,120	.81
Denver	2,275	2,050	1.10	5,585	5,370	1.04
Honolulu	2,176	1,689	1.18	(2)		
Albuquerque	2,109	1,393	1.51	4,544	3,288	1.38
Portland	2,284	2,026	1.12	5,192	5,126	1.01
Salt Lake City	2,105	1,692	1.24	4,933	4,161	1.19
Seattle [1]	2,664	1,989	1.33	5,711	5,235	1.09
Spokane	2,077	1,770	1.17	4,499	4,223	1.06
Tacoma	1,986	1,815	1.09	4,607	4,640	.99
Mean	2,221	1,970	1.14	4,910	4,910	1.01
Total, mean	1,987	1,948	1.05			
Standard deviation	254	383	.21			

[1] Multiple cities.
[2] City and county consolidated and therefore relationships are not applicable.

Source: 1960 data from ACIR, "Trends in Metropolitan America," 1975 data from U.S. Bureau of the Census, General Revenue Sharing Data Book, 1977.

TABLE 7.—DISTRIBUTION OF THE POVERTY POPULATION AND PERCENT BELOW THE POVERTY LEVEL, CENTRAL CITY AND SUBURBAN, 1969 AND 1976

[1970 metropolitan area definition]

Type of residence	1969	1976
Percent distribution by residence:		
United States (thousands)	27,204	24,974
Percent	100.0	100.0
Metropolitan areas, total	56.0	61.0
Central cities	34.0	38.0
Suburban areas	22.0	23.0
Nonmetropolitan areas	44.0	39.0
Percent below the poverty level:		
United States	13.8	11.8
Metropolitan areas, total	11.2	10.7
Central cities	14.9	15.8
Suburban	8.1	6.9
Nonmetropolitan areas	19.3	14.0

Source: U.S. Bureau of the Census, Social and Economic Characteristics of the Metroplitan and Nonmetropolitan Population: 1977 and 1970, Current Population Reports, P–23., No. 75, November 1978.

TABLE 8.—TRANSFER PAYMENTS AS A PERCENTAGE OF TOTAL RESIDENT LABOR AND PROPRIETOR INCOME, URBAN COUNTIES[1]

	Percent of income, 1975	Percent change, 1970–75
Growing:		
Houston (Harris)	8.1	17.3
Jacksonville (Duval)	15.3	54.0
Memphis (Shelby)	15.6	43.9
Phoenix (Maricopa)	18.7	66.9
San Antonio (Bexor)	21.2	53.4
San Diego	24.5	47.5
Average	17.2	47.2
Formerly growing, now declining:		
Columbus (Franklin)	15.3	57.9
Denver	17.4	35.7
Indianapolis (Marion)	13.9	50.0
Kansas City (Jackson)	17.4	60.7
Los Angeles	18.1	40.8
Average	15.4	49.2
Declining:		
Baltimore	25.0	73.6
Boston (Suffolk)	31.7	59.3
Buffalo (Erie)	20.4	52.5
Chicago (Cook)	15.4	57.0
Cincinnati (Hamilton)	16.0	51.2
Cleveland (Cuyahoga)	16.0	42.3
Detroit (Wayne)	19.6	77.2
Milwaukee	16.3	48.2
New Orleans (Orleans)	21.2	40.7
Philadelphia	27.0	62.7
Pittsburgh (Allegheny)	18.6	43.8
St. Louis (Cook)	28.0	66.6
San Francisco	22.6	37.2
New York (New York, Bronx, Kings, Queens, Richmond)	25.0	59.1
Average	21.6	55.1

[1] Adjusted for residents working in county but living outside of county. The names of the counties are in parenthesis. If not given, the name of the county and the central city in the county are the same or the city is a city-county.

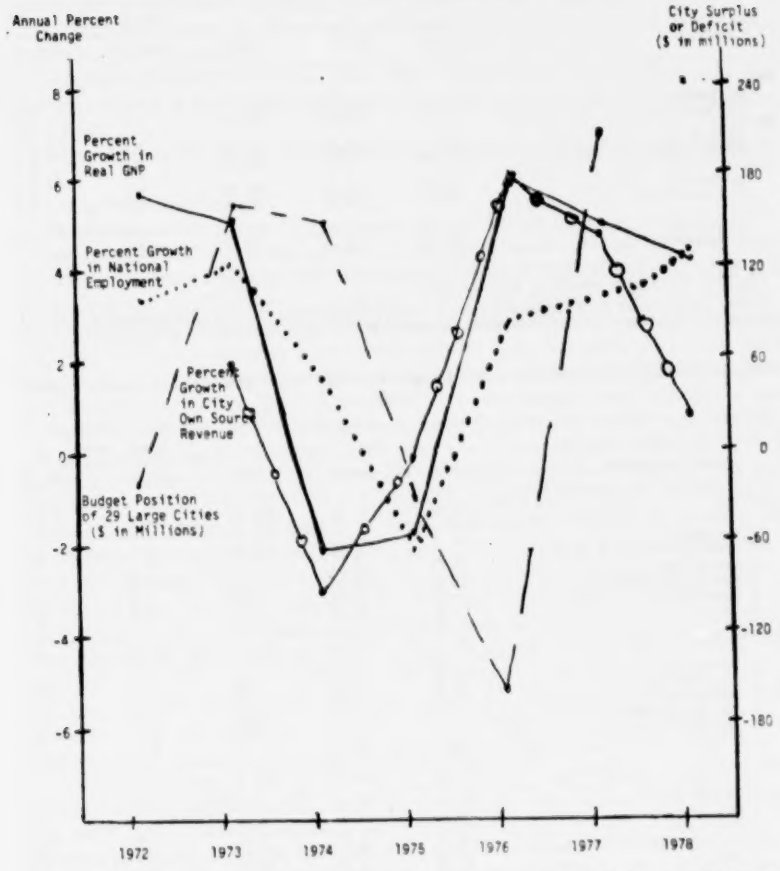
Source: County Business Patterns.

TABLE 9.—EMPLOYMENT AND UNEMPLOYMENT IN CENTRAL CITY, SUBURBAN AND NONMETROPOLITAN AREAS, 1970 AND 1977

Sex and labor force status	March 1977			April 1977		
	Central cities	Suburban areas	Nonmetropolitan areas	Central cities	Suburban areas	Nonmetropolitan areas
Total:						
Number employed	24,594	36,088	27,539	24,943	28,701	22,316
Percent change, 1970–77	−1.4	25.1	23.4			
Unemployment rate (percent)	9.1	7.3	7.6	4.8	3.9	4.6
Males:						
Number employed	13,967	21,648	16,572	14,702	18,269	14,168
Percent change, 1970–77	−5.0	18.5	17.0			
Unemployment rate (percent)	9.1	6.6	7.1	4.5	3.4	4.0
Females:						
Number employed	10,627	14,440	10,967	10,241	10,432	8,148
Percent change	3.8	38.4	34.6			
Unemployment rate (percent)	9.1	8.2	8.3	5.1	4.7	5.7

Source: U.S. Bureau of the Census, "Social and Economic Characteristics of Metropolitan Population: 1977 and 1970," Current Population Reports, P–23, No. 75, November 1978.

FIGURE 1.—*National economic trends and city fiscal health*[1]



[1] Annual percentage change figures are measured on the left vertical axis. The budget position of cities is measured in millions of dollars on the right vertical axis.

Sources: Budget position is from table 1; own source revenue growth is from table 2; GNP is from the "Survey of Current Business," July 1979; employment is from employment and earnings, November 1979.

TABLE 10.—CENTRAL CITY UNEMPLOYMENT RATES (S.A.)

[In percent]

	1974	1975	1976	1977	1978	1979	March 1980
National rate	5.6	8.5	7.7	7.0	6.0	5.8	6.2
Los Angeles	7.6	10.9	9.9	9.0	7.7	6.2	6.2
Atlanta	6.7	11.8	11.5	9.5	7.4	6.6	7.0
Washington	5.3	7.4	9.1	9.7	8.5	7.5	6.6
Chicago	5.2	8.9	8.5	7.3	7.3	6.4	6.4
Detroit	8.5	14.5	11.1	9.9	8.3	10.3	15.0
New York	7.2	10.6	11.2	10.0	8.9	8.7	8.8
Cincinnati	5.5	8.9	8.3	7.3	6.4	6.6	6.6
Pittsburgh	5.7	8.5	8.6	8.2	7.5	6.3	6.9
Houston	3.7	4.2	4.8	4.7	4.2	3.5	4.7
Seattle	6.5	9.4	8.8	8.4	5.9	5.3	5.4

Source: U.S. Department of Labor, Bureau of Labor Statistics, June 6, 1980.

TABLE 11.—CURRENT REVENUES AND CURRENT EXPENDITURES PER CAPITA

City size	1978 (actual)	1979 (actual)	1980 [1]	Percent change 1978–79	Percent change 1979–80
Small:					
(a) Revenue	$270.11	$281.03	$292.07	4.0	3.9
(b) Expenditures	261.07	285.86	309.24	9.5	8.2
Medium:					
(a) Revenue	284.17	293.02	300.79	3.1	2.7
(b) Expenditures	266.95	282.15	302.19	5.7	7.1
Large:					
(a) Revenue	332.94	352.32	365.76	5.8	3.8
(b) Expenditures	335.29	355.78	381.31	6.1	7.2
Largest:					
(a) Revenue	424.15	444.32	459.35	4.8	3.4
(b) Expenditures	409.71	443.25	466.51	8.2	5.2

[1] Budgeted or anticipated amounts for fiscal year 1980.

Source: "Trends in the Fiscal Condition of Cities," a study prepared for the use of the Subcommittee on Fiscal and Intergovernmental Policy of the Joint Economic Committee, Congress of the United States, Apr. 20, 1980.

TABLE 12.—COMPOSITION OF CURRENT GENERAL REVENUES IN PER CAPITA AMOUNTS AND ANNUAL PERCENT CHANGE

Total current revenue	1978 (actual)	1979 (actual)	1980 [1]	Percent change 1978–79	Percent change 1979–80
Small cities	$270.11	$281.03	$292.07	4.0	3.9
1. Property tax	110.56	107.74	114.43	−2.5	6.2
2. Other local taxes	57.31	64.59	69.16	12.7	7.1
3. User charges	13.60	14.72	14.98	8.2	1.6
4. Fees and miscellaneous	33.56	35.49	34.00	5.8	−4.2
5. State aid [2]	37.72	42.18	43.67	11.9	3.5
6. Fed aid [2]	17.36	16.24	15.83	−6.4	−2.5
Medium cities	284.17	293.02	300.79	3.1	2.7
1. Property tax	105.98	100.53	108.52	−5.2	7.9
2. Other local taxes	56.50	62.89	66.79	11.3	6.2
3. User charges	17.28	16.86	18.72	−2.4	11.0
4. Fees and miscellaneous	37.63	43.57	39.85	15.8	−8.5
5. State aid	37.11	43.83	44.14	15.4	3.1
6. Fed aid	29.67	26.34	22.79	−11.2	−13.5
Large cities	332.94	352.32	365.76	5.8	3.8
1. Property tax	124.94	121.96	130.49	−2.4	7.0
2. Other local taxes	68.16	75.08	78.80	10.1	5.0
3. User charges	15.93	16.35	18.20	2.6	11.3
4. Fees and miscellaneous	41.47	48.13	48.10	16.1	−.1
5. State aid	47.28	56.30	60.21	19.1	6.9
6. Fed aid	35.16	34.50	29.97	−1.8	−13.1
Largest cities	424.15	444.32	459.35	4.8	3.4
1. Property tax	120.67	109.89	114.38	−8.9	4.1
2. Other local taxes	104.39	114.07	123.71	9.3	8.5
3. User charges	20.36	22.14	25.12	8.7	13.5
4. Fees and miscellaneous	50.24	57.07	63.67	13.6	11.6
5. State aid	59.83	72.00	68.16	20.3	−5.3
6. Fed aid	68.65	69.15	64.30	.7	−7.0

[1] Budgeted or anticipated amounts for fiscal year 1980.
[2] Includes only that aid used for operating purposes.

Source: "Trends in the Fiscal Conditions of Cities," ibid.

Representative BOLLING. Now, our very patient members will have an opportunity to question the witnesses. I will ask each member to hold himself down to 10 minutes on the first round. I will stay until everybody is worn out.

Representative MITCHELL. Mr. Vice Chairman, I would like to make a request that it be 5 minutes on the first round. I will be forced to leave at 11:30.

Representative BOLLING. All right, without objection we will do that.

Congressman Long.

Representative LONG. Thank you, Mr. Vice Chairman.

My compliments to all of you. I thought each of you made a very substantial contribution. Mr. Rohatyn, I would like to join in with the vice chairman in his compliments to you. You are out in a little different arena than the rest of us. You have shown political courage in being willing to move into a field with which you weren't familiar and stayed in it. I am glad you weren't able to get out of the situation you walked into in New York 5 years ago. I encourage you to keep it up.

In addition, the strong ideas you have presented, which are worthy of consideration, I followed these over the years as you made them and I think you are performing another valuable service. That is, you are helping us all to realize that these problems are not simple. Politicians, particularly, have a tendency to look for simple solutions to complex problems. These problems, as you have pointed out here in your suggested approach to some solutions to them is clear evidence of an understanding that they are not simple. That they are very complex. They are going to require complex solutions and not across-the-board, general sweep-of-the-wand solutions. This is important. This is more important than you, and business who deal that way all the time, would realize, particularly when it comes to an ability to convince political leaders of that, and particularly the Members of the Congress who have to deal with as many subjects as we are forced to deal with.

Two questions I would have in my first 5 minutes. What is the danger if we form something comparable to the RFC of then ending up with trying to preserve a steel industry, which may no longer be competitive worldwide, and an automobile industry which itself may no longer be competitive worldwide, and consequently end up perhaps pouring good money after bad to a very substantial degree? Is there an increased likelihood of our doing this if we do create something such as the RFC?

Mr. ROHATYN. Congressman Long, that is a very fair question. I have a notion that we nationally can't afford to have a noncompetitive steel industry, but that we have to have a steel industry from a national security point of view. We can't, from a social-economic point of view, have a domestic automotive industry that produced 5 million automobiles per year. The inflationary impact of unemployment, leaving aside the whole human sociological cost is too great. Therefore, my

answer is that you have to have something, an economic tool, that can restructure industries that have become noncompetitive because of international factors, but also because of local management and labor failures, and that learning from the experience we had in New York City where we were able to induce labor to make sacrifices or able to induce the financial community by making sacrifices, where in effect the Municipal Assistance Corp. functioned like an RFC because we could say, "We will put our billion dollars in but only if we obtain the following concessions from labor, from business." Only that way, I think, can you ultimately do the basic restructuring that you have to make in those older industries.

The automotive industry will require huge amounts of capital. I don't think you can restructure Chrysler by doing it in front of the Senate Banking Committee. You don't have the mechanism to negotiate the way it should be negotiated. I think the capital that you will need is equity capital. It isn't loan guarantees, simply putting additional debt on a company already overburdened with debt. That doesn't cure the problem.

You can only do this if you have an independent, nonpolitical capital-providing agency that can also withhold capital if the other sacrifices don't come along. If labor doesn't come along and make its contribution, if management doesn't come along and make its contribution, if the other financing agencies involved in these corporations don't come along and make their contributions.

Representative LONG. Looking at the political situation, such as we find ourselves in now, the main emphasis seems to be on getting the Federal Government out of everyone's business. Do you think this would be accepted even in the business community, assuming that it's politically feasible to getting something like that enacted? What was your reaction in New York? Could we, at the national level, learn something in that respect from the experience you had in New York?

Mr. ROHATYN. The same business leaders who will rail against an RFC as putting the Government in business jumped up and down with glee when we suggested a wage freeze in New York and created MAC, when we took over tax revenues and restructured the finances of the industry. To me it is not even an ideological question.

Ultimately if we have a recession as deep and long as we think might be the case—nobody can be sure—and you have six companies, two in the automotive industry, three airlines, two banks, God knows what else, all lining up in front of the Senate Banking Committee because they are going bankrupt, you wouldn't let them go bankrupt.

I am suggesting you ought to have a mechanism to do this rationally and at the same time wind up with companies that are more competitive internationally than these companies are today as a national issue.

I don't think, in my 5 years of education in public life here, the one thing I learned is that it is impossible to simply roll things back. You can accomplish sacrifice from all parties only if you have an entity that can provide some element of hope.

There is no real hope in providing $1½ billion guarantees to a company that will have all its equity wiped out by its losses in terms of where it will be 3 years from now, but there is hope if you have an overall restructuring plan that shows the company with a different capital structure, and different labor contracts, and different produc-

tivity standards and maybe different management. It is not a perfect answer. It is now riskless. But again coming back to the industries, you wouldn't save our older cities and regions without having our older industries which are absolutely tied in with them providing competitive employment.

To me, the basis—I may oversimplify things—I don't think we would have a fiscal problem in New York City if black unemployment in the ghetto was 10 percent instead of 50 or 40 percent.

Representative LONG. I would like to explore this further when I have time. Thank you.

Representative BOLLING. Congressman Mitchell.

Representative MITCHELL. Thank you, Mr. Vice Chairman. I want to commend you and the committee for putting on this hearing. I make my apology for having to leave for a while but I will try to come back. I have scribbled some questions down here. I would hope that if I don't get back in time, I would be able to submit them to the witnesses for response. I wanted to take the time to speak to one or two statements that have been raised by the witnesses.

A few years ago at a time of great tragedy in our country, a militant, black nationalist made a very unfortunate statement that I could not condone. The statement was the "chickens have come home to roost." I really think that that statement is totally applicable of the condition of our urban centers. The chickens have come home to roost in the sense that this Nation has never really implemented policies for the full employment of black citizens and minorities in this country.

The hard fact of the matter is that since the end of World War II, for more than 35 years, the black rate of unemployment has always been twice as high as the white rate. In good times, bad times, boom, recession, always twice as high. In that sense, I think we are talking about the persistence of racism which still stands at the hiring gate, and because it does, I think it is rather naive and simplistic to talk about disincentives when we refer to black unemployment. I think that is rather simplistic. The fact of the matter is that a few years ago we created a million jobs in the private sector. A million jobs a year for 3 years. Because we did that we substantially reduced the rate of white unemployment. But we didn't even approach reducing the rate of black unemployment. Why?

The answer, it seems to me, is clear. It is not that a person does not want to work. It is not that he wants this aid from the Federal Government in the form of welfare, inadequate and pitiful as it is. It is a matter of that person not being able to attack in any effective fashion the racism which still stands at the hiring gate in the private sector.

I think it is again naive to talk about a subminimum wage for youth. What you are talking about, it seems to me, is attempting to impose a kind of condition in America that we abhor in South Africa.

Every American in this country abhors the conditions of blacks working in the coal mines in South Africa, being paid a pitiful, inadequate wage. Somehow we would want to attempt to impose that on black and minority youth, failing to realize that they are contributors to family income, failing to realize that whatever those youth might earn might help that family lift itself up a little bit. I will submit all of the questions. My time is up. I would like to go on record, Mr. Vice

Chairman, as being one who would oppose across-the-board tax cut as of this time.

I think the danger of an arbitrary across-the-board cut at this time lies in fanning additional inflation, that is just too great and I bitterly oppose it.

Thank you for letting me make a statement. With your permission, Mr. Vice Chairman, I would like to send a list of questions to the witnesses.

Representative BOLLING. Without objection, it is so ordered. I would agree to that.

Congressman Reuss.

Representative REUSS. Thank you, Mr. Vice Chairman. The panel has presented a most melancholy view of the immediate future: Bad inflation, bad unemployment, low growth rates, big disparities between the have and have-not States, no real signs of change evident. I would like to ask the witnesses a question, and I will exempt from the questioning Mr. Laffer and Ms. Shalala. I wouldn't embarrass either of them. But let me ask the remainder of the witnesses, now that the party platforms are in and now that the candidates are in, or practically in, whether they envisage the 1980 election as being one of those great periods of national education and revival where one or the other party is presenting the issues which might lead us out of our troubles. Do any of the witnesses want to say three cheers for the state of Democratic or Republican dialog? [Laughter.]

Mr. ROHATYN. Well, Congressman Reuss, I find—again, for purpose of disclosure, I suppose I am a registered Democrat, an unenchanted but registered Democrat. However, I am equally disenchanted and depressed looking at really both sides of the political dialog here. It seems to me that if anything, the Republican platform, as I read it—I know people don't govern on platforms but they seem to me a reflection of philosophy—really glosses over what to me is the greatest problem basically facing this country, which is the energy problem.

I don't think you can make it go away by unleashing the oil industry, by abolishing the 55-mile-an-hour speed limit, by thinking you are going to find more oil in Alaska than there is in Saudi Arabia. I think the energy problem, the fact that we spend $100 billion a year on oil imports now annually as opposed to $10 billion 5 or 6 years ago, that that $100 billion is about 10 percent of the value of every company listed on the New York Stock Exchange, which means we are burning into the atmosphere every day 10 percent of our productive capacity. That flow of imports puts enormous pressure on the dollar continuously. That pressure reflects itself in a requirement to keep high-interest rates in the country to keep the dollar from collapsing and creates a dynamic that is prorecession because you can never get out of this bind the way you are going.

As soon as you stimulate the economy, the dollar goes under pressure, interest rates go up and you are back down again. It seems to me that that is underneath the very strange functions of our economy which are both inflationary and recessionary simultaneously as a result of this extraordinary tax imposed on the Western World. I think the current administration has at least recognized the problem without being able to really mobilize the country behind it.

I think, as I indicated earlier, I would favor a much stiffer gasoline tax than the 10 cents, if it were capable of being adopted, as a way of providing some of the capital that must be used to rebuild this country.

In my 5 years, half in private and half in public life, I learned a lot about the problems public officials face in terms of a murderous electorate that makes it almost suicidal to really take tough positions. On the other hand, it can be done. Our Governor in New York State at the end of the 1975 fiscal crisis when we did impose tuition at the university, increased transit fares, was very tough, was very popular. People understood what was happening.

You have to have the media continue to explain it to them. You have this dynamic of an electorate that seems bored and doesn't seem to believe anybody. Yet the problems are there. The longer you wait for them to be resolved, the worse they get until the structural imbalances in our society will be so great that you will have breakdowns. But I think the dialog is primitive. It is uninformative. It is linked with all kinds of passions which have no business in this. And underneath it all, there is this extraordinary desire and yearning to go back to simple answers which just don't exist any more.

For better or worse we are in the last quarter of the 20th century. We are not in the 19th century though we might be going toward the Middle Ages.

Representative REUSS. My 5 minutes is up, but I would comment that I and a lot of others share your gloomy view of the present campaign as a producer of new solutions which are so desperately needed. It seemed to me, however, that maybe one should not blame entirely Carter and Reagan, the Democrats and Republicans, because before every great new movement there has to be a John the Baptist. Ralph Nader for the consumers, Rachel Carson for the environment, and so on. There really hasn't been such a person for the whole problem of energy, inflation, recession, governmental relations, which I guess covers what you have been talking about. So continue your dire focus. We really are going to need somebody like that before you are ever going to get the political process to move. There may not be too much time. My time is up.

Representative BOLLING. I will pick up from that comment. I agree with what Congressman Mitchell said because I am a southerner. I don't think there is any question that the country is decades behind in dealing with its racial problems. I think it now intends to deal fairly but it hasn't been successful in working out its built-in problems. But I think any society which fails to take into account such a fundamental problem is almost doomed. No society that can produce as much affluence as we have for as many people can afford to have, at the same time, so many comparatively ghastly enclaves.

I have come to a conclusion I would like to share with all of you. It's not a new conclusion. I don't happen to think this country works very well by parties. I don't think it ever has. I came in a very long time ago and I came in without knowing that we had in place a policy that was going to work rather well for about 20 years. It had all gone in place at a time of political turmoil in the late 1940's and early 1950's.

We didn't even know it was there when Mr. Eisenhower was elected President to do very few aggressive things as President. But the policies worked rather well. They were set up by bipartisan groups

which were partly political, partly nonpolitical; which, in fact, involved an alliance of the society, inside and outside the political process. I believe that it, rather deliberately, with the cooperation and leadership of the business community and the political community and the labor community determined to have a new economic policy, which was sort of new. It was never honored on the down side. Always on the up side. I think I detect a little of that around these days but it isn't called that.

Then our country had a foreign policy and defense policy that could be rolled into something called the Marshall plan. It wasn't passed by politicians. It was passed by society. At the same time remarkably the society reformed itself through the Hoover Commission and through the Monroney Act. The Hoover Commission reorganized the Executive and the LaFollette-Monroney Act made changes. Our real problem, and you addressed it. Mr. Rohatyn, very clearly in a variety of places, we only function well together when we work together. All of these things interlock. For example, I frankly believe that regardless how important the choices are for President and for Congress—and I never thought a good Democrat that came from Truman's county, a good New Dealer, Fair Dealer, et cetera, would be saying this in public—regardless who the people of the United States choose, it really has very little to do with the future policies of the United States. The reason is we are in enough trouble now so that the real choices can only be effectively made by the society as a whole. The leaders may be people who may not be known by name today. They may or may not be Presidents or members of the Cabinet. They may be people who, like the then head of Studebaker, Paul Hoffman, turned out to be a key mover and shaker in the execution of policy as well as in the formation of policy.

I don't know if anybody remembers him now but there he was. He wasn't considered even a major force in the business community. He just was a very influential person. I think a bipartisan coalition will save us, if we are to be saved.

Congressman Long.

Representative LONG. Mr. Rohatyn, I had two questions I wanted to explore with you. Do a little thinking out loud for me. Assume Congress had the political courage and ability—I am not sure it did—I know we didn't have the political courage then and I am not sure it could have been done under practically any circumstances—but in the 1973–74 embargo, right at the time of Watergate—let's assume we had the ability to recognize the seriousness of the energy problem at that time. Assume we had the ability to recognize the problem and take effective political action with respect to it. Assume that political action had been the enactment of the 50-cent-per-gallon tax on gas at the time. How do you see the world economic and U.S. economic situation different from what it is at present had that occurred?

Mr. ROHATYN. I think you would have had a number of things today that would be very different. First of all, instead of having whatever it was, $500 or $600 billion go out of this country over the last 7 years, my guess is you would have had a significant reduction in the import bill that we would have been paying for crude oil. Second, again depending on what you did with the revenues raised, you could have

financed a synthetic fuel industry. You could have lowered other business taxes. You could have lowered payroll taxes. You could have had significant impact on the inflationary bias that exists in this economy.

Third, the automobile companies, which have made mistakes—however, it's a fact of life that in 1974–75 they couldn't give away compact cars because people saw 60-cent gas and thought V–8 engines and tail fins were terrific. If you had $1.50 gas in 1974 there would have been an enormous demand for fuel-efficient cars in the country. There would have been the tax revenues and cash flow to generate the changeover. You wouldn't have the situation where imports account for 28 percent of automotive production because we would have had cars ready to fill that demand.

These are only—I am citing a few instances. If you had also done something in 1973–74 when our weakness vis-a-vis OPEC wasn't as obvious as it is today, you could have negotiated with Iran, with Saudi Arabia, with Kuwait, different methods of payment for oil coupled with some different defense arrangements that wouldn't leave us in a position today when the whole country gets nervous if Public Broadcasting puts on a program that depicts Saudi Arabia in a questionable light. It seems to me that as a world power, our inability to face this particular situation has resulted in a squandering of our world position that I find unequaled in modern history.

Representative LONG. Mr. Liner, one question. With respect to the development of the Sunbelt and the area that you study, what are the principal factors to which you attribute the fact that Florida and Texas have been responsible for about 50 percent of the economic growth of the Sunbelt during the last 10 years?

Mr. LINER. Congressman Long, there is no question but what the differential tax rates, whether it's income, property, or sales, do provide an attractive inducement for major organizations to move from, let's say, New York to Texas. On the other hand, we recognize there is a push-pull factor at work. A lot of companies feel they are being taxed out of business in other parts of the country.

The critical question as to why more of this attraction doesn't spill over into other States that appear to have equally attractive tax structures is one of the mysteries. Most still go to Texas and Florida. At the same time we find at least a half dozen other States with parallel tax systems and very active State and local recruitment programs for industries. And while those two States, Texas and Florida, have very different resource bases with respect to national resources, we find others with similar assets that still have not been able to attract industry.

So I don't think there is an easy answer, and I certainly wouldn't want to contribute to any of the myths about location or migration of firms.

Representative LONG. I have no further questions.

Representative BOLLING. Congressman Reuss.

Representative REUSS. Mr. Bahl, in your prepared statement, you point out that in the last decade, the States, far from finding themselves and exercising a meaningful role in working out the problems of their creatures, local government, have gone the other way. They have shucked them off. More and more the Federal Government deals di-

rectly with the city and local government. To an increasing extent, States are cutting down in their aid to localities as a method of solving their problems.

You ask the question in your prepared statement, "Is fiscal centralization to be encouraged or not and should States—as a prerequisite to Federal assistance—be required to deal with the city-suburb disparities problem?" I take it that you would answer that question yes. You would say, yes, the States should be required to stop copping out on the city-surburb disparity problem; would you?

Mr. BAHL. I would certainly answer that question with a "yes." I guess I was making the point that it would be a reasonable part of any statement of national urban policy to raise that question and answer it as part of the policy. I think for a lot of reasons, many of which I have heard you talk about, States are in a position to deal with the city-suburb problem. On this subject, a point I rarely hear from representatives from the growing region, but one I always wondered why not, is: Why should there be a call for a redirection of Federal moneys to subsidize the cities in the North, when you can't bring your own suburbs to share in those problems?

The only way we can do that is through the States.

Representative REUSS. Yes, as you just said, I broke a lance on that question in the last 10 years. I suggested when revenue sharing was first passed that nothing go to the States unless they at least prepare a plan for solving their city-suburb fiscal problems.

In the second go-around on revenue sharing, the League of Women Voters took over and got the proposal through a subcommittee, but then that failed and was never heard from again. So sadly, 10 years of State revenue sharing didn't accomplish much of anything. It is now abandoned, many millions of dollars going down the rat hole, with the situation, if anything, worse in respect to the problem.

Isn't that a fair analysis of what happened?

Mr. BAHL. Except for the part about the rat hole, I think I agree with what you said. I think probably we made little or no strides by way of forcing States to be somehow accountable for the city-suburb disparities.

Representative REUSS. But what happened was that States in many cases repealed or lightened upon their progressive tax steps, because they were getting Federal funds which they could use for many of their State purposes without any necessity of their achieving any reform. So I really don't know what has been accomplished. The Nation's total tax system has been made more regressive and less progressive than it was. Perhaps it's something to do with our combined inflation and recession.

At any rate, I think your point is well taken. Thank you.

Representative BOLLING. Thank you. I think the witnesses will be inundated with questions in writing that will come probably from members and through me from staff, and I hope you will bear with us and be as kind as you can in responding.

Now I would like to ask if the witnesses would like to ask any questions of other witnesses. Sometimes that is fruitful. Sometimes it is not. Sometimes it's wise to make that a direction. Mr. Bahl gave the main paper, the paper that started it all. Are there points in his paper that some of you would like to raise questions about? In other words,

you have a shooting license at each other, and you can even ask us questions, if you would like.

Mr. ROHATYN. I would like to ask you for your own views as to the possibility, or any of the witnesses' views, of really realistic congressional or Federal action in terms of some of the really deep-seated structural and regional problems we face. Speaking just in terms of MAC, in terms of New York City and New York State, we are going to embark on another time-buying operation that will be very painful. The only ultimate justification for doing it—there are two. One, I don't think we have any other choice.

Second, whether there will ultimately be any combined city-State-Federal actions that are going to address some of these problems.

Representative BOLLING. I am willing to try to answer that, because I have a very strong opinion on it. You are sort of turning on a waterfall, not a faucet. What I said earlier with regard to what happened in the late 1940's, I recognize deals with a much less complicated situation. We had every advantage in the world, the latest fine, major industrial economy. We had all the prospects. We realized in the first 20 years that we used rather magnificent economic growth as a conscious engine of social change.

We had a whip or two that affected the society rather equally. We were all, without exception, frightened of depression, and we were almost all frightened of aggression, so we had some fears. We have some fears now that we didn't have 4 years ago or perhaps 2 years ago. We should have had them for reasons that you and others outlined. But I happen to believe very strongly, as a practicing politician of some 40-odd years that there is something very peculiar about the way that country works in terms of adopting policy.

My field was history before I became a politician. I hope someday to have the time to look at some of the other surges forward this country took to see if it is again a coalition.

But I begin to see forming today the combination of circumstances that will make us willing to act and the combination is that we face a recession which may be—you were careful, and I will be careful—a good deal worse than anything we had before—a collapse of our major industries for reasons that I think you have outlined rather well, and judiciously, without a partisan or a special interest point of view.

There is a mood in the country that we are in a great deal of trouble. A group I am associated with had a good poll done by a skilled person, Garth, and it showed that the American people are far ahead of most of its leaders in recognizing how much trouble we are in. Therefore, I think the atmosphere is correct, and I think that whoever is elected President, whoever dominates the Congress—and there are all kinds of possibilities in a year like this—may turn into a coalition builder. I haven't seen a political year like this since 1952, which was really a culmination of 1946, 1948, and 1952. It's a wide open year. Almost anything can happen. Probably not all of it will be good. In any event, almost anything can happen. But I believe whoever is the President is going to be required and is already committed to the notion that he has to pull together a coalition of the people of the country to work in some fashion to fashion new policy.

Let us take energy, for example, I felt very strongly about energy. believe it or not, in 1953 and 1954. There was quite an excellent report

Mr. Truman commissioned at that time which predicted virtually everything—except the timing, but still it excited me. I had some interest in that, and I tried to talk about it for perhaps 4 or 5 years and frankly gave up. But when 1972 came along and 1973, I tried again and went through the effort to do something about energy. I voted for the tax increases that you suggested whenever I had an opportunity. I think our high tide was 76 votes in a House of 435.

But that is not anybody's fault, except that it wasn't done right. The way you do it right—I will use one example—is the way the Marshall plan was passed. My first political activity was as a local representative of the Committee for the Marshall Plan in Kansas City, Mo. Truman was for the Marshall plan but didn't have a chance to get it through Congress. There wasn't a prayer. If they hadn't turned it into something bipartisan that emerged famous, they wouldn't have had a prayer. It didn't have a prayer. My first job was to convert my predecessor on behalf of the Committee for the Marshall Plan to being for the Marshall plan, where he was announced against it.

The effort we were able to bring to bear on him, which was bipartisanship, and a major leadership group in the United States pressing all together for the Marshall plan is the reason it passed. It wasn't an accident. It was political action by groups that didn't have a partisan label. Partisan labels were pulled together symbolically—Marshall and Vandenberg. Business, labor, agriculture, the major ingroups were pulled together by enlightened leaders in and out of politics. I am absolutely convinced—maybe I can be accused of this being an act of faith, but if it is, it's rather like yourself—with even a longer experience in the public sector and no real experience in our sector—I am absolutely convinced we are right on the verge of having one of those creative moments in our history.

How it is done, I can't foresee, but I made some other proposals that I won't go into now about examination of the Government by a tripartisan, if you will, commission—a variety of things that I think might lead the way. I believe the things that you are talking about must happen if the country will survive. Therefore, if this is a good, honest act of faith, I think they will happen.

Mr. ROHATYN. I hope you are right. I pray that you are.

Representative BOLLING. Are there additional questions? [No response.]

Thank you very much one and all. You have been very patient with us. Please be patient with us when we send you more questions.

The committee stands adjourned.

[Whereupon, at 11:50 a.m., the committee adjourned, subject to the call of the Chair.]

[The following questions and answers were subsequently supplied for the record:]

RESPONSE OF ROY BAHL TO ADDITIONAL WRITTEN QUESTIONS

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., August 4, 1980.

MR. ROY BAHL,
Metropolitan Studies Program, 409 Maxwell Hall, Syracuse University, Syracuse, N.Y.

DEAR MR. BAHL: When the hearing adjourned last week, I told you because of the time constraints, we were going to have to mail you some additional ques-

tions. As you recall, Congressman Mitchell said he had some in particular. For your information, these are questions 3, 4, 5, and 6. Because of the special time constraints of our Study, we'd appreciate your response to the questions as soon as you can. I know from Debbie and others the amount of time you have already put in for us and hope this additional time will be well worth adding, so that we can have the kind of final product I know we both want.

Here are the questions:

Considering the difficulties we have had with the targeting issue, and considering also the problems of Southern-rural poverty, isn't there a good case for more direct Federal aid to disadvantaged people, and relatively less to distressed places?

What do you think of helping the poor and unskilled go to where manufacturing jobs are opening up, rather than trying to bring manufacturing jobs to the poor where they live?

It has been pointed out that many States have surpluses. These surpluses should be used to cover program areas hurt because of reduced Federal spending. The question is, "over a period of the next 10 years, will most States continue to run surpluses?"

In consideration of the fact that fewer dollars will be going to the States in the future, should not we forget the use of those Federal dollars? Should we return to categorical grant programs because they are more easily monitored?

At present, many cities are attempting to lure whites back, hoping to strengthen their tax base. Will gentrification or regentrification in any way help inner-city minorities to move from their present status in part characterized by gross unemployment and deplorable housing?

If gentrification or regentrification is successful over the long haul, what do you see the future of displaced minorities to be?

How do you think our complicated State—local arrangement can be modified in ways that can help streamline the U.S. industrial system within the world economy?

Is it fair to say that the most urgent fiscal problems in the next few years will be confined to the State and city governments of the Nation's northeast quadrant?

Let's switch the focus for a moment from governments to people; considering the difficulties we have had with the targeting issue, and considering also the problems of Southern-rural poverty, isn't there a good case for more direct Federal aid to disadvantaged people, and relatively less to distressed places?

Thanks again for your help so far, Roy. I think the hearing was a definite success, and I hope it serves as a good launching pad for your book.

With best wishes.

Sincerely,

RICHARD BOLLING, *Vice Chairman.*

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SYRACUSE UNIVERSITY,
Syracuse, N.Y., August 14, 1980.

Hon. RICHARD BOLLING,
Vice Chairman, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR CONGRESSMAN BOLLING: I am more than happy to take the time to respond to the questions you have raised.

I will take your questions in the order you posed them, in the following paragraphs.

Certainly there is a good case to be made for more targeting to disadvantaged people—that is something we can come close to measuring. I guess my caution on that is that a great deal of the improvement of the quality of life for poor Americans comes through services which are provided by state and local governments. Education, protective services, and the kind of infrastructure services which generate or hold on to jobs are all potentially redistributive. These kinds of services simply can't be supported with more direct assistance to individuals. As difficult as the problem of measuring governmental distress appears to be, I believe we must find some best acceptable measure. The real question is what provides the most help to disadvantaged people—direct aid to them or improved governmental services. I would counsel on not backing too quickly away from the latter.

I would argue very strenuously that we ought to provide assistance to move the poor and unskilled to where the job opportunities for them exist. The revitalization of central city economics through increased manufacturing employment is simply not in the cards. There is not a shred of evidence that it can work to any significant degree. More fortunate people in our society are able to move when job opportunities shift, but the poor and unskilled require federal assistance to identify and make the moves. Over the next ten years it looks as though the oil and gas producing states will run considerable surpluses. In general, I would expect the pattern to be much like it was in the mid and late 1970's—the state and local government sector will run an aggregate surplus during recoveries and a deficit during recessions. In my earlier manuscript I pointed out many weaknesses with the surplus as a measure of fiscal health. Another, that perhaps was not so emphasized in the paper, is that some governments may run small surpluses because they choose to tax at very low levels and provide very low levels of public services. If we had such a measure as an "adequate public service level surplus" (sort of like the full employment budget surplus at the federal level) I would expect to see the growing states of the south and west accumulate surpluses over the next decade while the declining state of the Northeast and Midwest would continue in a deficit position.

I guess I'm going to have to consider the next question more carefully before I provide anything like a complete answer. The more I study the Federal grant system the more I believe that it is completely out of control. No one has any idea about the net effects of the total grant system—rather a few people have some idea about the net effects of programs in which they are particularly interested. In fact, the monitoring of a single program more carefully than another may involve state and local governments adjusting the uses of grant A in order to compensate for some kind of mandate on grant B.

I think one can hold out very little hope that revitalization/gentrification will provide any significant help for inner-city minorities. First of all, there isn't any evidence that a gentrification movement is improving the fiscal or economic health of cities. To the extent such a movement will proceed during the next decade, it likely will improve the physical conditions of inner-city housing and perhaps keep the tax base from declining as quickly as it might otherwise have. On the other hand, it also will likely work in the direction of displacing low income families from the housing they occupy in the inner-city. It is hard to see how such effects, particularly when they are likely to be so very small, will do much for Black Americans. It also is probably worth noting that the gentrification movement will be pretty much a large city phenomenon. Minorities in the smaller metropolitan areas—who are too often forgotten in all of these discussions—will likely benefit even less.

If, in fact, gentrification were successful—and I take this to mean not that it would completely revitalize the central city but that it would renew some of the older housing stock—the likely effect would be to drive displaced minorities into the oldest, adjacent suburbs. One can see this to some extent in the Washington area as a "Prince Georges County effect." There are older suburbs around many of the metropolitan areas that could be identified as candidates for a similar out migration. The net effect is simply to transfer poor living conditions, education levels, public services, etc. from the innter-city to an old suburb.

There is no question but that the federal/state/local government system needs to be rearranged and modernized and it is very important that you do not leave the federal government out of that. Federal policy to a large extent shapes the relationship between the states and their local governments. The first need is a simplification of the federal grant programs and mandates. We need to understand what the federal government is trying to make the state/local sector look like through its carrot/stick approach and to find some way of evaluating the success of that approach. Second, the major, problem to deal with is the separation of city and suburban jurisdictions in the old northeast. It gives rise to the kind of unhappy fiscal social and economic disparities that most of us have been talking about for two decades. We need to find a way to induce states to eliminate the series of wasteful competitive subsidies that they use to try and attract industry from one place to another. We probably could also benefit by a reduction in the taxation of capital by state and local governments. Finally, we badly need some kind of fiscal planning so that one could identify cities and

states that are candidates for financial emergencies, before those emergencies occur. I guess I would add that another major need is for the federal, state and local sector to get it straight in their heads about what role the state government will play in the system. I had a fair bit to say about that in my written testimony and in the manuscript.

I think that the most urgent fiscal problems in the next few years will probably occur in the Northeast and Midwest. The cities that are candidates for financial emergency—and those whose emergency may be hastened by the recession—tend to be the older manufacturing based cities. However, there are candidates even in the growing region, though such distressed cities are far fewer in number. In the chapter on distress in the manuscript, I listed those which I tought were candidates for relatively early financial emergencies.

Thanks again for the opportunity to work with you and the committee—I'll look forward to reading the full set of special studies.

Best regards,

ROY BAHL, *Director.*

RESPONSE OF ARTHUR B. LAFFER TO ADDITIONAL WRITTEN QUESTIONS

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., August 4, 1980.

Mr. ARTHUR B. LAFFER,
Professor, Department of Finance and Business, School of Business Administration, University of Southern California, Los Angeles, Calif.

DEAR MR. LAFFER: When the July 28 hearing adjourned, I indicated that additional questions would be mailed to you. I would, therefore, appreciate your cooperation in responding to the following questions:

Mr. Bahl urges against establishing unrealistic expectations about revitilization. He does not believe the older industrial cities can ever again be the cities they were 20 years ago. Do you agree?

Would your tax incentives actually bring new manufacturing jobs back to cities like Buffalo, Cleveland, or St. Louis, cities whose industrial decline reflects national and even global forces?

A recent article in The Wall Street Journal concluded that States pay dearly through inducements and tax breaks but gain little in their effort to lure industry. In fact, an Economic Development Administration study was cited which found no relationship between the level of State taxes and job creation or investment. Why would enterprise zones have an impact when these other efforts do not?

What do you think of helping the poor and unskilled go to where manufacturing jobs are opening up, rather than trying to bring manufacturing jobs to the poor where they live?

It has been pointed out that many States have surpluses. These surpluses should be used to cover program areas hurt because of reduced Federal spending. The question is, "over a period of the next 10 years, will most States continue to run surpluses?"

In consideration of the fact that fewer dollars will be going to the States in the future, should we forget the use of those Federal dollars? Should we return to categorical grant programs because they are most easily monitored?

At present, many cities are attempting to lure whites back, hoping to strengthen their tax base. Will gentrification or regentrification in any way help inner-city minorities to move from their present status in part characterized by gross unemployment and deplorable housing.

If gentrification or regentrification is successful over the long haul, what do you see the future of displaced minorities to be?

Thank you again for your very constructive contribution to an important hearing.

With best wishes.

Sincerely,

RICHARD BOLLING, *Vice Chairman.*

UNIVERSITY OF SOUTHERN CALIFORNIA,
SCHOOL OF BUSINESS ADMINISTRATION,
DEPARTMENT OF FINANCE AND BUSINESS ECONOMICS,
Los Angeles, Calif., August 21, 1980.

HON. RICHARD BOLLING,
Vice Chairman, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR CONGRESSMAN BOLLING: In response to the questions you sent me recently, I would make the following comments:

I do not agree that the cities cannot be revitalized. The problem is partially taxation and the disincentives inherent in the welfare system. With proper policies, the cities can be restored to economic health and vitality.

It is quite likely that tax incentives would bring new manufacturing jobs back to the cities. While there are other factors beside taxes which also matter, without a good tax climate, the cities will continue to decay.

While the Economic Development Administration's study concluded that there isn't any relationship between the level of state taxes and the creation of jobs and investment, other research in this area demonstrates that changes in the level of state taxes do matter. This relationship has been demonstrated empirically as quite strong in explaining the relative growth rates of personal income among the states. A reduction in marginal tax rates in urban areas would allow the proposed enterprise zones to succeed far better than specialized tax breaks and special inducements to lure industry. Such policy approaches have not been shown as effective. A reduction in the marginal tax rates would, I believe, have more impact on the economic problems of the cities.

The decision whether to bring the poor and unskilled workers to the location of the jobs, or bring the jobs to the areas where the poor live is one which must be based on costing factors by the industries concerned. This may be particularly true for larger businesses which have many additional factors to consider in their location decisions. But many smaller businesses could also flourish in the enterprise zones, and would be linked to the communities where the poor and unskilled workers reside. The subject of locating workers and plants is one which requires additional study.

State surpluses are possible, even likely, if national economic fiscal policies are implemented. If the levels of taxation, welfare spending, etc., continue to rise at accelerated rates, then surpluses are very unlikely, and deficits almost certain. If there are major reductions in the marginal tax rates at the national level, then surpluses at the state level are more likely due to the increased tax base and growing economy. Also, the expanding economy would lessen the demand for transfer payments, and other government spending areas, which would further contribute to surpluses.

I have not researched, and cannot give a considered opinion now on the matters of categorical grants and gentrification.

It was an honor to testify before your committee, and if you have any additional questions, please feel free to inquire.

Sincerely,

ARTHUR B. LAFFER.

RESPONSE OF DONNA E. SHALALA TO ADDITIONAL WRITTEN QUESTIONS

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., August 4, 1980.

MS. DONNA E. SHALALA,
Assistant Secretary for Policy Development and Research, Department of Housing and Urban Development, Washington, D.C.

DEAR MS. SHALALA: When the July 28 hearing adjourned, I indicated that additional questions would be mailed to you. I would, therefore, appreciate your cooperation in responding to the following questions:

Mr. Bahl urges against establishing unrealistic expectations about revitalization. He does not believe the older industrial cities can ever again be the cities they were 20 years ago. Do you agree? What do you think are realistic expectations?

It has been pointed out that many States have surpluses. These surpluses should be used to cover program areas hurt because of reduced Federal

spending. The question is, "over a period of the next 10 years, will most States continue to run surpluses?"

In consideration of the fact that fewer dollars will be going to the States in the future, should not we forget the use of those Federal dollars? Should we return to categorical grant programs because they are more easily monitored?

At present, many cities are attempting to lure whites back, hoping to strengthen their tax base. Will gentrification or regentrification in any way help inner-city minorities to move from their present status in part characterized by gross unemployment and deplorable housing?

If gentrification or regentrification is successful over the long haul, what do you see the future of displaced minorities to be? Will those displaced be shifted to county ghettoes? What will be their fate?

Many cities have undertaken the revitalization of their downtown areas hoping to lure businesses, tourist, etc., thereby ultimately creating employment opportunities for inner-city residents? Is this not the trickle down theory? Do you know of any instances when the trickle down approach has had a positive effect on structural or cyclical unemployment which dominate inner-city life?

What do you think of helping the poor and unskilled go to where manufacturing jobs are opening up, rather than trying to bring manufacturing jobs to the poor where they live?

How can our complicated State-local arrangement be modified in ways that will help streamline the U.S. Industrial system within the world economy?

Do you still believe that manufacturing is the past, not the future, of our older cities, and that attempts to restore the city manufacturing base are "Like pushing a boulder uphill?"

From what I had heard about your views before the hearing, I had the feeing that you didn't think there was a great deal of prospect for the kind of city-focus re-industrialization that Felix Rohatyn proposes? Do you still feel this way?

What do you think of measures to help the poor move to where unskilled jobs are opening, in the suburbs and in growing regions?

Thank you again very much for your very constructive contributions to what I consider to be a most important hearing. As you may know, this hearing is part of our effort to make a contribution in our Special Study on Economic Change to the very important area of State and Local Governments. We hope to be publishing our Study early in the Fall so that the sooner we could get these answers to round out our considerations, the more helpful it would be.

With best wishes.

Sincerely,

RICHARD BOLLING, *Vice Chairman.*

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DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT,
Washington, D.C., August 27, 1980.

Hon. RICHARD BOLLING,
Vice President, Joint Economic Committee,
Congress of the United States, Washington, D.C.

DEAR MR. BOLLING: On behalf of Donna E. Shalala, I am transmitting answers to the questions you raised in your letter of August 4, 1980.

As you will note, these responses are provided on the enclosed sheets. Please feel free to contact me if you wish HUD to provide further discussion on these topics.

Sincerely yours,

MICHAEL A. STEGMAN
(For David F. Garrison, General Deputy Assistant Secretary)

Enclosure.

1. I agree with Mr. Bahl's observation. During the last ten years, the U.S. has clearly entered an era of urban decline as evidenced by population and job loss. The 1970's represent the first time in this nation's history that central cities, as a group, have experienced absolute population decline. Moreover, U.S. metropolitan areas are losing population relative to their surrounding non-metropolitan areas and in some metropolitan areas there is even an absolute loss occurring.

The 1970's represent the first time in this nation's history that central cities, (the central city is noisier, more crime ridden, and provides inferior public services such as schooling when compared to its suburbs), reduced access to jobs, and unintended consequences of pro-suburban federal government policies such as the development of the interstate highway system, FHA mortgage insurance, and the deductibility mortgage interest payments from the federal income tax.

Equally significant is the economic structural change occurring in our cities: there is a clear pattern of a shift in the urban industrial base away from the traditional manfuacturing, transportation and communication functions toward services and government. As a result, the cities are not only becoming characterized by a lower wage structure but, in addition, the revenue base is being inexorably eroded.

While the cities must not look to the past for their future role, one should not conclude that expectations need to be bleak. Cities are continuing to develop as centers of commerce. They are retaining and in some cases expanding their share of the nation's service sector activity. The increasing cost of energy could accelerate these trends, making central city economies and tax bases stronger.

2. The outlook for state government budget during the next few years hinges on four key factors: (1) the bargaining strength of public employees, (2) the intensity of inflation (the higher the rates the greater the fiscal strain), (3) the ability of the nation to emerge from current economic stagnation, and (4) the ability of these governments to increase worker productivity and reduce its scope of public services. Realistically, I think that the outlook for most states is not one of fiscal ease and budget of surpluses, but, rather of continued budgetary strain. Certainly some states will do well—particularly those in our oil producing regions. Overall, however, the view that somehow the states are going to be in surplus and thus replace federal programs is largly wishful thinking.

3. Probably not. Rather than go the categorical route, it would be preferable to rely more heavily on unconditional aid which is monitored for its targeting to certain kinds of localities having social, economic, and fiscal needs. The need for fewer federal strings which characterize categorical aid is evident even in the General Revenue Sharing (GRS) program. GRS is, of course, our prime example of a block grant. However, recent evidence indicates that even this program has a sufficient number of strings and federal requirements so as to make it inaccessible to some of our smaller cities and towns.

4. In reality, the issue is not purely a racial dichotomy, but one of income. As you know, one of the major problems of the nation's capital city is its growing loss of high and middle income blacks, as well as whites, to the suburbs. Given this, the answer to your question as to whether middle income reinvestment, or gentrification will have any benefit for inner city poor is "yes." Certainly, there are problems of residential displacement of some persons as part of a city revitalizes, but our research at HUD suggests that this is not an unmanageable problem. If the city and its poor residents are going to have any chance of improved living environments in the coming years, reinvestment by middle income persons should be encouraged. The alternative—to encourage federal or state/local policies designed to slow inner city revitalization will simply have the result of equalizing income—everyone who stays behind will be poor.

5. As I indicated. displacement is a serious problem for some families, and a legitmate public policy issue. There is some risk that suburban ghettoes may develop if we simply turn away from the fact that those who are displaced need assistance. This help ran range from short run relocation assistance to housing subsidy and jobs programs.

6, 7, and 11. Questions 6, 7, and 11 are closely related and so I have chosen to answer them together. I prefer to refer to this issue in question 6 as the multiplier theory. "Trickle down" usually refers to housing stock and is not a very descriptive or accurate term here. Apart from that semantic clarification, I believe your questions focus on a topic which we at HUD have long discussed as one possible explanation for how suburbanization has worked to harm the inner city poor—*viz*, the skills/jobs "mismatch." There are two facets to this hypothesis, both focusing on a mismatch between the types of job skills possessed by city residents and the kinds of jobs available within the city. The first and most popular form of the hypothesis is that the new and expanding industries in a city are those which tend to provide "white collar" (e.g., professional) jobs with relatively high entrance requirements—jobs not compatible with the remaining city residents. The second view is that the best and newest of the blue collar and low skilled jobs are moving to or being created in the suburbs where they are less accessible to city residents.

Clearly, if the mismatch hypothesis is found to be generally true for declining urban areas, the prospects for the city resident are dismal indeed. Characterized as being less mobile than jobs and capital, the city resident is trapped in the city with little opportunity for reverse (city to suburb) daily job commuting. The suburban resident, by contrast, is seen as having the opportunity for employment near home or for commuting to the city to the new, high-skilled opportunities located here.

Ultimately, of course, just how dismal this mismatch can become may be largely a function of public policy response. It provides an excellent example of a public policy choice—either to help people adjust to the new urban economic reversal by encouraging commuting and outmigration to suburban jobs or by retraining residents within the city for available jobs there.

Despite its conceptual neatness, however, some economists argue that as a general rule the data simply do not support the alleged mismatch. Rather it is argued that there has been sufficient job growth to accommodate virtually all of the unemployed in central cities if, in fact, the jobs had gone to them. If this view is empirically correct then the policy implications are different from those which flow from the mismatch hypothesis. Rather than helping the city through programs aimed at easing the adjustment processes, the real attention will need to be given to determining why the city worker fails to get new growth jobs in the city.

Unfortunately, there is not a great deal of evidence of, and therefore agreement upon which of these viewpoints serves as a good policy framework. What we can say with some certainty is that from an efficiency view it makes good sense to at least attempt to create jobs in the inner city where the least mobile of our population resides. Thus there is much merit in helping a community lure business, even tourist business, to downtown areas. Ideally, of course, one would like to attract the type of business which is characterized by upward labor mobility and relatively high wages—i.e., manufacturing, construction, and general "white collar" work. If this type of business cannot be lured downtown—and there are reasons to believe it cannot—then we may have to consider direct policies of helping people commute out to suburban jobs.

8. I prefer to speak of the state-local relationship as "diverse" rather than complicated. The complications that do exist in our intergovernmental system—federal, state, local—are in large part due to the overlapping federal grant-in-aid structure we have created. If intergovernmental "complication" is the problem, perhaps we need to look at our own level of government first. The point is that by stressing diversity in our state and local relationships—including the relationship among the states—lessons are often learned which help rather than hinder sound public policies. The big roadblocks to industrialization stem from factors such as federal tax and regulatory policy, not the inherent diversity in state and local governments.

9. Yes. This is true because the reasons underlying this manufacturing base loss are fundamental structural ones. They include technological changes in the production and distribution process which favor non-urban locations, international factor price changes which tend to have a relatively large impact on "old" industries historically associated with urban manufacturing, and the general state of the national economy which, as discussed above, contributes to the fiscal deterioration of the city.

10. Yes.

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